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Alert

Seventh Circuit Changes Its Mind and Reverses "Inconsistent" District Court Fraudulent Transfer and Equitable Subordination Ruling

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The U.S. Court of Appeals for the Seventh Circuit held on Aug. 26, 2013 that an investment manager's "failure to keep client funds properly segregated" and subsequent pledge of those funds "to secure an overnight loan" to stay in business may have constituted: (a) a fraudulent transfer to the lender; and (b) grounds for equitably subordinating the lender's $312 million secured claim. *In re Sentinel Management Group, Inc.*, 2013 WL 4505152, *1 (7th Cir. Aug. 26, 2013) ("*Sentinel II*"). Reversing and remanding the case to the district court for further litigation because of "inconsistencies" in that court's opinion, the Seventh Circuit found that the debtor manager's "pledge of segregated funds as collateral for loans" was likely a fraudulent transfer based on an "actual intent to hinder, delay or defraud" creditors under Bankruptcy Code ("Code") §548(a)(1)(A). *Id.*, at 6.

The court stressed that a "good faith-for-value" defense by the lender on remand will be "very difficult because it will have to prove that it was not on inquiry notice of [the debtor's] possible insolvency." *Id.*, at *6 - *7n.2. On remand, the lower court also must, because of "inconsistencies throughout" its opinion, "clarify . . . exactly" what the lender knew and whether its "failure to investigate" the debtor was "reckless" or "deliberately indifferent." *Id.*, at *11. Missing from the recent Court of Appeals decision, however, was any mention of its earlier Aug. 9, 2012 decision ("*Sentinel I*") *affirming* the district court on the same facts. 689 F. 3d 855, 863, 866 (debtor's failure to segregate "client funds . . . not . . . sufficient to rule . . . that [debtor] acted with actual intent to hinder, delay or defraud its customers"; "incompetence alone, however problematic, won't require the equitable subordination of the [lender's] lien.").

Relevance

Sentinel II is of critical importance to so-called "rescue" lenders. A close reading of the facts shows that these loans are still risky, but feasible in certain cases. In terms of legal analysis, the decision deals with: (a) the meaning of the Code's actual intent to "hinder, delay, or defraud" creditors' language; (b) whether actual intent to cause *harm to* creditors must be proved; (c) what constitutes "egregious and conscience shocking" behavior for a lender's claim to be subordinated on equitable grounds; and (d) whether the parties' illegal behavior makes a contract intrinsically illegal. If nothing else, the case shows how the Seventh Circuit itself wrestled with this decision and changed its mind over a two-year period after oral argument on September 8, 2011. Indeed, the district court itself struggled with the issues following a seventeen-day bench trial. "After hearing from more than a dozen witnesses, listening to audio recordings between [the parties], and reviewing hundreds of exhibits," it dismissed the trustee's claims. *Id.*, at *5.

Facts

The debtor investment manager had "marketed itself to its customers as providing a safe place to put their excess capital, assuring solid short-term returns, but also promising ready access to the capital." *Id.*, at *1. Its customers "were not typical investors; most of them were futures commission merchants" like broker-dealers in the securities industry. *Id.* In the debtor's hands, its "client money could, in compliance with industry

regulations governing such funds, earn a decent return while maintaining the liquidity" that clients needed. *Id.* "[The debtor] constructed a fail-safe system that virtually eliminates risk from short term investing," said the debtor's 2004 website. *Id.*

The debtor "represented that it would maintain customer funds in segregated accounts as required under the Commodity Exchange Act." *Id.* Thus, "at all times a customer's accounts held assets equal to the amount [the debtor] owed the customer, and . . . [the debtor] treated and dealt with the assets 'as belonging to such customer.'" *Id.*

The debtor "pooled customer assets in various portfolios, depending on whether the customer assets were" regulated or unregulated funds. *Id.* at *2. Because the debtor did not differentiate between its own funds and its customers' non-segregated assets, it "could sell securities or borrow the money" whenever customers wanted their capital back." *Id.* "This arrangement allowed [the debtor] to borrow large amounts of cash while pledging customers' securities as collateral." *Id.* Nevertheless, the debtor "maintained segregated accounts [with] assets that could not be subject to any [lender] lien." *Id.* The lender agreed it had no lien and would "not assert" a "lien against securities held in a Segregated Account." *Id.* Although the debtor was responsible "for keeping assets at appropriate levels of segregation," the lender's "main concern was ensuring that [the debtor] had sufficient collateral in the lienable accounts to keep its . . . loan secured." *Id.*, at *3.

The debtor went through a liquidity crunch during the summer of 2007. *Id.* In a series of transactions, the debtor moved securities from segregated accounts to "lienable accounts." *Id.*, at *4. A lienable account, however, could contain only securities and other assets that belonged to the debtor or that were not subject to segregation. When the debtor's "segregation deficit grew to $644 million, [the lender] became suspicious." *Id.* A managing director of the lender emailed colleagues involved with the debtor's accounts, asking how the debtor had "so much collateral? With less than [$2 million] in capital I have to assume that most of this collateral is for somebody else's benefit. Do we really have rights on the whole $300MM?" *Id.* The lender's officials knew the debtor "had an agreement that gave the [lender] a lien on any securities in clearing accounts." *Id.* By Aug. 13, 2007, the debtor told its customers "that it was halting redemptions because of problems in the credit market," causing the lender to cut the debtor's "remote access to its systems, . . . [to send] its officials to [the debtor's] offices, demand . . . full repayment of the loan, and threaten . . . to liquidate the collateral." *Id.* The debtor then filed a Chapter 11 petition, owing the lender $312 million. *Id.*

The court ordered the appointment of a trustee who later became the post-plan confirmation liquidating trustee. When the lender filed a $312 million secured claim, the trustee sued the lender, alleging that the debtor had "fraudulently used customer assets to finance the loan to cover its house trading activity"; the lender "knew about it and, as a result, acted inequitably and unlawfully," giving rise to fraudulent transfer and equitable subordination claims, including invalidation of the lender's lien. *Id.*, at *5.

The District Court

The district court "dismissed the lien invalidation count on the pleadings," and held a lengthy bench trial on the trustee's other claims. According to the lower court, after trial, the trustee had "failed to prove that [the debtor] made the Transfers with the actual intent to hinder, delay or defraud its creditors." *Id.*, at *5. The district court also "rejected the [trustee's] preference claim because the [lender] was over-collateralized on the transfer dates." *Id.* It further rejected the trustee's equitable subordination claim "because it did not believe that [the lender's] conduct was 'egregious or conscience shocking,'" reasoning that the lender's employees "had no legal obligation . . . to seek out or analyze the data . . . that would have revealed [the debtor's] misuse of the segregated funds." *Id.*

Attacking the lender's secured claim, the trustee made three arguments in the lower court. First, the debtor had "acted with actual intent to hinder, delay, or defraud when it borrowed money from the [lender]," making the lien avoidable by the trustee for unsecured creditors. Second, the lender had "engaged in inequitable conduct when it allowed [the debtor] to borrow money," thus entitling the trustee to subordinate the lender's lien "to the claims of unsecured creditors." *Id.* Finally, the trustee asserted that the debtor's "contracts with the [lender] violated the law on their face," requiring invalidation of the lender's lien. *Id.*

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The Unmentioned Sentinel I
The trustee appealed the dismissal of his complaint, leading to the Seventh Circuit's original affirmance of the district court on Aug. 9, 2012 — *Sentinel I. In re Sentinel Management Group Inc.*, 689 F. 3d 855, 861; 862-63; 865-66 (7th Cir. 2012) (*held*, debtor had not transferred "customer assets out of segregation" to lender with "actual intent to hinder, delay or defraud its creditors"; trustee proved "at most" only debtor's insolvency at time of transfers; debtor's failure "to keep client funds properly segregated is not, on its own, sufficient to rule . . . that [the debtor] acted with requisite intent"; "proving actual fraud . . . requires more than simply showing that the transfer resulted in an under-segregation of client funds"; "use of customer assets as collateral for a loan that served purposes that did not directly benefit the customers [to repay debtor's repurchase agreement counterparties] does not mean" debtor had requisite intent; debtor's "preference of one set of creditors (the [lender], whose funds paid off the repo counterparties) over another (its customers) is properly reserved for [trustee's] preferential transfer claims," which district court properly rejected because lender was "over-collateralized on the transfer dates"; debtor "made transfers to pay off one set of creditors in an attempt to save the enterprise from sinking"; "actions taken to survive a financial storm" don't require finding of actual intent; defendant lender's secured claims should not be equitably subordinated because bank "was not an insider," and was not guilty of "egregious misconduct"; "incompetence alone, however problematic, won't require the equitable subordination of the [lender's] lien") (citing *Boston Trading Grp. v. Burnazos*, 535 F. 2d 1504, 1508-09 (1st Cir. 1987) (Breyer, J.) (fraudulent transfer law does not include attempts "to choose among" creditors); *Dean v. Davis*, 242 U.S. 438, 444 (1917) (Brandeis J.) ("Making a mortgage to secure an advance with which the insolvent debtor intends to pay pre-existing debt does not necessarily imply an intent to hinder, delay, or defraud creditors"); *In re Sharp Int'l Corp*, 403 F. 3d 43, 56 (2d Cir. 2005) ("The $12.25 million payment was at most a preference between creditors and did not 'hinder, delay or defraud either present or future creditors.'"). The Court of Appeals withdrew *Sentinel I* in late 2012 with no explanation, merely stating that the opinion had been withdrawn and the judgment vacated.

The Later Court of Appeals Decision: Sentinel II
The court never even mentioned *Sentinel I* in its Aug. 26, 2013 opinion (*Sentinel II*). It first found that the debtor had transferred the funds to the lender with "actual intent to hinder, delay, or defraud" creditors, thus enabling the trustee to avoid the Lender's lien as a fraudulent transfer. *Id.*, at 7. "[I]nconsistencies in the district court's opinion regarding the extent of the" lender's knowledge prior to bankruptcy "lead to further inconsistencies regarding the mental state of" the lender's employees. *Id.*, at 10. "If [the lender's] employees knew that [the debtor's] insiders were misusing loan proceeds, then it certainly suggests that [those] employees (at the very least) turned a blind eye to the rest of [the debtor's] misconduct." *Id.*, at 10. "The district court . . . appears to waffle back and forth between characterizing their mental states as negligent and as reckless." *Id.* On remand, after the district court "clarifies" the facts, it will have to "revisit the ultimate issue of whether the [lender's] claim merits equitable subordination." *Id.*, at *11.

Fraudulent Transfer
The district court, while conceding the debtor's insolvency, "did not believe [that the debtor's] behavior was enough to prove that [the debtor] possessed the actual intent to hinder, delay, or defraud other creditors. . . . [It apparently believed] that [the debtor] had robbed Peter ([other clients]) to pay Paul ([the lender]) in the months before it filed for Chapter 11, . . . [concluding] that this behavior was not enough to show . . . actual intent to hinder, delay, or defraud [other creditors]. Rather, [it] characterized [the debtor's] behavior as a desperate 'attempt to stay in business.'" *Id.,* at *6.

The Seventh Circuit rejected the district court's analysis. "[W]e disagree with the district court's legal conclusion that such motivation was insufficient to constitute actual intent to hinder, delay, or defraud" the debtor's clients. *Id.* "Such a result too narrowly construes the concept of actual intent. . . ." *Id.* Although the debtor may have genuinely believed that it was merely trying to stay in business, it "certainly should have seen our treating these transfers as fraudulent as consistent with our construction of actual intent to defraud in other contexts." *Id.*

The court also dismissed the district court's findings as to the debtor's good intentions. "[E]ven if we assume that Sentinel had the best intentions for its . . . clients when it pledged the segregated funds, the fact remains that Sentinel knowingly exposed its . . . clients to a substantial risk of loss of which they were unaware." *Id.*, at 7. The debtor's "pledge of the segregated funds as collateral for its own loan" became "particularly egregious when viewed in light of the legal requirements imposed . . . by the Commodity Exchange Act . . . ." *Id.* ". . . Sentinel did more than just expose its . . . clients to a substantial risk of loss of which they were unaware;

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Sentinel, *in an unlawful manner*, exposed its . . . clients to a substantial risk of loss of which they were unaware." Even if it did not intend to harm its clients, its "intentions were hardly innocent." *Id.* More important, if the lender had "sufficient knowledge to place it on inquiry notice of the debtor's possible insolvency," it will have a "very difficult time proving that it was not on inquiry notice of" the debtor's egregious conduct. *Id.*, n.2. In other words, the Lender's knowledge of sufficient facts showing egregious misconduct will deprive it of any "good faith-for-value" defense.

Equitable Subordination

The district court found the lender's conduct here to be neither "egregious nor conscience shocking." *Id.*, at *9. But the Seventh Circuit found the lower court's findings to be "internally inconsistent." *Id.* On one hand, the district court found the lender to have known "Sentinel was engaging in wrongful conduct before its collapse." *Id.* On the other hand, the lower court found that the lender's "employees . . . neither knew nor turned a blind eye to the improper action of Sentinel." *Id.* This waffling "throughout the opinion" caused the Court of Appeals to question the district court's ultimate findings that the lender's claims should not be equitably subordinated. *Id.*, at *11. On remand, therefore, the district court must "clarify" exactly what the lender knew; what it knew of the debtor's misconduct; and the level of the lender's failure to investigate — "was it reckless? Or was it deliberately indifferent?" *Id.*

Legality of Contracts

According to the Court of Appeals, the district court had "correctly dismissed the trustee's claim that the lender's contracts with the Debtor were 'inherently illegal.'" *Id.* Because the "contracts did not require either [the debtor] or the [lender] to do anything illegal, and because there was no "evidence [suggesting that the contract between the parties] was connected with an illegal scheme or plan," the defense of "illegality" was "inapplicable" here. *Id.*

Comments

1. Rescue lending is not dead because of *Sentinel II*. The seminal *Dean v. Davis* Supreme Court decision, cited in *Sentinel I*, confirms that an arm's length, good faith commercial loan will not be undone. *Dean v. Davis*, 242 U.S. at 444 (securing a loan *to* an insolvent debtor for payment of "a pre-existing debt does not necessarily imply an intent to hinder, delay or defraud creditors. The mortgage may be made in the expectation that thereby the debtor will extricate himself from a particular difficulty and be enabled to promote the interests of all other creditors by continuing his business. The lender . . . may be acting in perfect 'good faith' . . . . It is a question of fact in each case what the intent was with which the loan was sought and made.").

2. In *Dean*, the rescue lender (the debtor's brother-in-law), lost his mortgage because of his special knowledge and participation in the debtor's misconduct. ". . .[K]nowing the facts, [he] cooperated in the bankrupt's fraudulent purpose, lacked the saving good faith . . . ." *Id.*, at 445. The lender in *Sentinel II*, however, still has an outside chance of proving that it had made a secured loan in good faith, without knowledge of the debtor's improper activities. The lender lives for another round of litigation.

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