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Court Validates Rescue Loan, Rejecting Equitable Subordination and Fraudulent Transfer Claims

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A bank did not engage in "egregious conduct" sufficient to subordinate its lien on equitable grounds, held the U.S. District Court for the Northern District of Illinois on Dec. 10, 2014. *In re Sentinel Management Group, Inc.*, 2014 WL 6990322 (N.D. Ill. Dec. 10, 2014) ("*Sentinel IV*"). Moreover, because of the bank's "good faith," the corrupt borrower's fraudulent pledging of customer funds to the bank to secure a so-called $312-million rescue loan "cannot be avoided." *Id.* at *10. Of special relevance to "rescue lenders," *Sentinel IV* shows that rescue lending is still viable but not without its risks.

The U.S. Court of Appeals for the Seventh Circuit had previously held in August 2013 that the debtor investment manager's "failure to keep client funds properly segregated" and subsequent pledge of those funds "to secure an overnight loan" from the defendant bank to stay in business may have constituted: (1) a fraudulent transfer; and (2) grounds for equitably subordinating the bank's $312-million secured claim. *In re Sentinel Management Group, Inc.*, 728 F.3d 660 (7th Cir. 2013) ("*Sentinel III*"). Reversing and remanding the case to the district court for further litigation because of that court's "inconsistencies," the Seventh Circuit found that the debtor-manager's "pledge of segregated funds as collateral for loans" was likely a fraudulent transfer based on its "actual intent to hinder, delay or defraud" creditors under Bankruptcy Code ("Code") Section 548(a)(1)(A). *Id.* at 666. *See* M.L. Cook, "Seventh Circuit Reverses 'Inconsistent' District Court Fraudulent Transfer and Equitable Subordination Ruling," 31 *Bankr. Strategist*, No. 1 (November 2013).

The Seventh Circuit stressed in *Sentinel III* that the bank's "good faith-for-value" defense 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." 728 F.3d at 668 n.2. The Seventh Circuit directed the lower court, on remand, to "clarify … exactly" what the lender knew and whether its "failure to investigate" the debtor was "reckless" or "deliberately indifferent." *Id.* at 672.

The district court, in *Sentinel IV*, clarified its "prior opinion and findings of fact … based, not only on what the witnesses said, but, more importantly, also on the conduct and actions of witnesses." 2014 WL 6990322, at *1. First, "the trigger for equitable subordination … is whether [the defendant bank's] conduct is egregious and conscience-shocking." *Id.* After rejecting the trustee's equitable subordination claim because the bank's "employees were neither aware of nor deliberately indifferent toward [the debtor's] misconduct," *id.* at *7, the court conceded the *debtor's* "actual intent to defraud [its creditors]." The bank still had defenses, though, to the trustee's fraudulent transfer claims: Under Code Section 548(c), the bank, "as transferee, received liens … in exchange for giving value [$312 million] to [the debtor] in good faith." *Id.* at *8. According to the court, "even under a purely objective standard, [the bank] acted in good faith." *Id.* Moreover, the bank "loaned [the debtor] $312 million and [the debtor] provided an amount of collateral which secured the $312 million and no more." *Id.* at *10. Sustaining the bank's defense, the court stressed that the debtor's "assets … were not depleted; they were held as security for repayment of the loan … .[I]n exchange for the collateral, [the bank] gave [the debtor] a loan of significant value which only added to [the debtor's] asset pool." *Id.*

Relevance

Sentinel IV shows that rescue loans may be risky but are still feasible. In its legal analysis, *Sentinel IV* deals with: (1) what constitutes "egregious and conscience shocking" behavior for a lender's claim to be subordinated on equitable grounds; and (2) the "good faith for value" defense in Code Section 548(c), available when a debtor makes a fraudulent transfer. If nothing else, the case shows how protracted this kind of litigation can be. The transfers under attack were made in 2007; the district court's original decision came down in 2010; and the Seventh Circuit handed down two opinions, in 2012 and 2013. Indeed, before rendering its 2010 decision, the district court had "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 had initially dismissed the trustee's claims five years ago. 728 F.3d at 666.

Facts

The debtor investment manager ("Sentinel") 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." Its customers "were not typical investors; most of them were futures commission merchants" like broker-dealers in the securities industry. 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. Sentinel constructed "a fail-safe system that virtually eliminates risk from short term investing," said its 2004 website. *Id.* at 662.

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.* at 663.

The debtor "pooled customer assets in various portfolios, depending on whether the customer assets were" regulated or unregulated funds. 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," which allowed Sentinel to "borrow large amounts of cash while pledging customers' securities as collateral." *Id.* Nevertheless, Sentinel "maintained segregated accounts [with] assets that could not be subject to any [lender's] lien." The bank here agreed it had no lien and would "not assert" a "lien against securities held in a Segregated Account." Although Sentinel was responsible "for keeping assets at appropriate levels of segregation," the bank's "main concern was ensuring that [the debtor] had sufficient collateral in the lienable accounts to keep its … loan secured." *Id.* at 664.

Sentinel went through a liquidity crunch during the summer of 2007. In a series of transactions, it moved securities from segregated accounts to "lienable accounts in a series of transactions." *Id.* A lienable account, however, could contain only securities and other assets that belonged to Sentinel or that were not subject to segregation. When Sentinel's "segregation deficit grew to $644 million, [the bank] became suspicious." A managing director of the bank 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?" The bank's officials knew Sentinel "had an agreement that gave the [bank] a lien on any securities in clearing accounts." By Aug. 13, 2007, Sentinel told its customers "that it was halting redemptions because of problems in the credit market," causing the bank 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." Sentinel then filed a Chapter 11 petition, owing the lender $312 million. *Id.* at 665.

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

The 2010 District Court Decision ("*Sentinel I*")

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 court, the trustee had "failed to prove that [the debtor] made the Transfers with the actual intent to hinder, delay or defraud its creditors." The district court also "rejected the [trustee's] preference claim because the [lender] was over-collateralized on the transfer dates." It further rejected the trustee's equitable subordination claim "because it did not believe that [the bank's] conduct was 'egregious or conscience shocking,'" reasoning that the bank's employees "had no legal obligation … to seek out or analyze the data … that would have revealed [Sentinel's] misuse of the segregated funds." *Id.*

Attacking the bank'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 [bank]," making the lien voidable by the trustee for the benefit of unsecured creditors. Second, the bank 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." Finally, the trustee asserted that Sentinel's "contracts with the [lender] violated the law on their face," requiring invalidation of the bank's lien. *Id.*

The First Seventh Circuit Opinion ("*Sentinel II*")

The trustee appealed the dismissal of his complaint, leading to the Seventh Circuit's initial affirmance of the district court on Aug. 9, 2012. *In re Sentinel Management Group Inc.*, 689 F.3d 855, 861; 862-63; 865-66 (7th Cir. 2012) ("*Sentinel II*") (*held*, debtor had not transferred "customer assets out of segregation" to bank 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; debtor "made transfers to pay off one set of creditors in an attempt to save the enterprise from sinking"; "incompetence alone, however problematic, won't require the equitable subordination of the [bank's] lien") (citing *Boston Trading Grp. v. Burnazos*, 835 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 Seventh Circuit withdrew *Sentinel II* in late 2012 with no explanation and vacated the judgment of dismissal.

The Later Seventh Circuit Decision ("*Sentinel III*")
The court found in *Sentinel III* that the debtor had transferred the funds to the bank with "actual intent to hinder, delay, or defraud" creditors, thus enabling the trustee to avoid the bank's lien as a fraudulent transfer. "[I]nconsistencies in the district court's opinion regarding the extent of the" bank's knowledge prior to bankruptcy "lead to further inconsistencies regarding the mental state of" the bank's employees. 728 F.3d at 671. "If [the bank'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.* "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, said the Seventh Circuit, it will have to "revisit the ultimate issue of whether the [bank's] claim merits equitable subordination." *Id.* at 672.

The Seventh Circuit also rejected the district court's "rescue loan" analysis: "[W]e disagree with the district court's legal conclusion that such motivation [i.e., rescue] was insufficient to constitute actual intent to hinder, delay, or defraud" the debtor's clients. "Such a result too narrowly construes the concept of actual intent … ." 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 668. 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 … . Sentinel did more than just expose its … clients to a substantial risk of loss of which they were unaware; 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.* (emphasis in original). More important, if the bank 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.* at n.2.

Equitable Subordination
The Seventh Circuit found the lower court's equitable subordination findings to be "internally inconsistent." *Id.* at 670. On one hand, the district court found the bank to have known "Sentinel was engaging in wrongful conduct before its collapse." On the other hand, the lower court found that the bank's "employees … neither knew nor turned a blind eye to the improper action of Sentinel." *Id.* at 671. This waffling "throughout the opinion" caused the Seventh Circuit to question the district court's ultimate findings that the lender's claims should not be equitably subordinated. On remand, therefore, the district court had to "clarify" exactly what the bank knew; what it knew of the debtor's misconduct; and the level of the bank's failure to investigate—"was it reckless? Or was it deliberately indifferent?" *Id.* at 672.

The district court first noted the applicable standards for equitable subordination of a non-insider's claims such as those held by the bank. According to the Seventh Circuit, "[c]ases subordinating the claims of creditors that deal at arm's length with the debtor are few and far between." *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7th Cir. 1990). Therefore, courts apply the doctrine only when they find: "(1) fraud, illegality, breach of fiduciary duties; (2) under-capitalization; [or] (3) claimant's use of the debtor as a mere instrumentality or alter ego." *In re Lifschultz Fast Freight*, 132 F.3d 339, 345 (7th Cir. 1997). These precedents informed the district court's fact-intensive analysis.

The district court in *Sentinel IV* agreed with the Seventh Circuit that it had been "internally inconsistent" in *Sentinel I* when describing the bank's conduct. To "clarify" its original opinion, the court made these findings:

- "[The debtor] could legally trade for itself, and [the bank] believed it did."
- "[The bank] did not know or believe that [the debtor] was engaging in misconduct before it collapsed."
- A bank employee's questions about the debtor's collateral "did not assume that all of it came from the accounts of [the debtor's] clients," but focused instead on whether the bank's "lien was enforceable."
- The debtor's "sudden demise … was a complete surprise to" the bank; it did not know that [the debtor] was on the brink of collapse" and "did not foresee the possible demise and default of" the debtor.
- The bank "neither knew nor turned a blind eye to the improper actions of" the debtor.
- " … [M]ere negligence—or ineptitude—is insufficient to establish inequitable conduct."
- "[I]t is not necessarily negligent or reckless to accept collateral without further checking its provenance, particularly where pledged securities had been used for a long time without problems for" the bank.
- "After years of successful loans to [the debtor]," the bank "had been reasonably satisfied with [the debtor's] representation … that it had the right to pledge the securities."
- The bank was "neither a father's keeper nor a partner … of those to whom it loans money for business operations."
- No evidence existed "that either the auditor or regulator—independent entities with the power of oversight over [the debtor]—knew or should have known of wrongdoing before [the debtor's] collapse."
- The bank "neither knew nor should have known that [the debtor] was misusing loan proceeds or participating in any other misconduct."
- The bank "acted within the realm of reason when it took great care to insure its loans were backed by adequate collateral."
- "[N]othing in [the debtor's] conduct throughout the banking relationship [caused the bank] to doubt [the debtor's] integrity."

- "… [N]othing in this [communication among] bank personnel [would cause] a reasonably prudent person [to] believe that [the debtor] had engaged in misconduct."
- "The decision to rely on the full lien ... is and was a reasonable policy choice for [the bank] to make."
- The trustee could not "simply show, after the fact, that [the bank] could have put together all the objective pieces of information that [the bank] had about [the debtor] and should have known it had to investigate [the debtor's] conduct."
- "…[T]he risk of hindsight bias often makes the purely objective information an unreliable and unfair ground on which to judge the conduct of [the bank's] officers."

Fraudulent Transfer
The district court also conceded its earlier error "when deciding … that Sentinel" lacked the requisite intent to defraud its creditors. 2014 WL 6990322, at *8. Although the Seventh Circuit corrected the error in *Sentinel III*, the district court, it said, had not addressed the "defenses available to" the bank. *Id.*

First, relying on Code Section 548(c), the district court in *Sentinel IV* held "that absent [the bank's] knowledge of bad conduct or its ignoring what it should have known … [it] has acted in good faith … even under a purely objective standard." As noted, the bank "did not know" that Sentinel had wrongfully pledged the collateral for its loan. "Moreover, any inquiry [the bank] might have made would likely have been fruitless, as [the bank] believed, even to its own detriment, the lies told by [Sentinel's principal]." *Id.*

Second, "nothing … would have or should have informed [the bank] that [the] long time set of transactions [between the parties] would suddenly change in nature." *Id.* at *9. The parties "had a fairly long history of extending loans and not needing to use the collateral [securing] Sentinel's loans." *Id.* at *10.

Finally, as noted earlier, the bank loaned Sentinel $312 million in exchange for the collateral from Sentinel. The loan "only added to Sentinel's asset pool." Because of the value given by the bank, held the court, the trustee "cannot force [the bank] to pay twice the value of its loan by avoiding" Sentinel's pledge. *Id.*

Comments
- Rescue lending is still alive because of *Sentinel IV*. The seminal *Dean v. Davis* U.S. Supreme Court decision, cited in *Sentinel II*, 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").
- The district court's consistent, detailed fact findings should make a reversal by the Seventh Circuit unlikely. Factual findings are reviewed in the federal courts of appeals only for "clear error." *Zervos v. Verizon N.Y. Inc.*, 252 F.3d 163 (2d Cir. 2001). A factual finding is clearly erroneous "when although there is evidence to support it, the reviewing court on the entire

evidence is left with the definite and firm conviction that a mistake has been committed." *United States v. U.S. Gypsum Co.*, 333 U.S. 364, 395 (1948). In the Seventh Circuit, "[t]o be clearly erroneous, a decision must strike us as more than just maybe or probably wrong; it must … strike us as wrong with the force of a five-week-old, unrefrigerated dead fish." *Parts and Elec. Motors, Inc. v. Sterling Elec., Inc.*, 866 F. 2d 228, 233 (7th Cir. 1988). At bottom, it was the bank's lack of knowledge and participation in Sentinel's fraud that helped it avoid liability.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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