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Seventh Circuit Voids Lien-Securing Rescue Loan

Rejects Equitable Subordination Claim

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A "bank [making a secured rescue loan] had information that should have created the requisite suspicion … to conduct a diligent search for possible dirt" — *i.e.*, whether the debtor had the right to pledge $312 million of customer securities, held the U.S. Court of Appeals for the Seventh Circuit on Jan. 8, 2016. *In re Sentinel Management Group, Inc.*, 2016 WL 98601, at *2 (7th Cir. Jan. 8, 2016) ["*Sentinel V*"].

The Seventh Circuit reversed the district court, voided the defendant bank's lien as a fraudulent transfer, and rejected the bank's good-faith defense. Based on the district court's detailed findings of inquiry notice, the Seventh Circuit stressed that "the bank had lent approximately $300 million to a company that had capital equal to roughly 1/150th of that amount" at a time when the debtor was mysteriously "able to secure the entire loan." *Id.* at *3. Because the "obvious" source of the collateral "was the [debtor's] customer accounts," and because "the bank had … documents [showing] on even a casual perusal … that [the debtor] lacked authority to pledge" the assets, the bank "was on inquiry notice that the assets … had been fraudulently" pledged to it. *Id.* at *6.

Nevertheless, the court of appeals affirmed the district court's refusal to subordinate the bank's unsecured claim because the bank's "negligence" was not "an adequate basis for imposing equitable subordination." *Id.* at *5. According to the court, "the trustee ha[d] not proved" that the bank knew the debtor "was securing the bank's loans with customers' money without their consent." *Id.*

Relevance

Sentinel V provides lenders with helpful guidance in the making of rescue loans. It not only shows the importance of "inquiry notice" to a lender's asserted "good-faith" defense, but it also shows what constitutes "egregious and conscience shocking" conduct for a lender's claim to be subordinated on equitable grounds. *In re Sentinel Management Group, Inc.*, 2014 WL 6990322, at *1 (N.D. Ill. Dec. 10, 2014) ("*Sentinel IV*"). *Sentinel V* is the fifth reported decision on this dispute in eight years of litigation. 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 prior opinions in 2012 and 2013. Before rendering its 2010 decision, *In re Sentinel Management Group, Inc.*, 441 B.R. 864 (N.D. Ill. 2010) ("*Sentinel I*"), the district court had "struggled with the issues following a 17-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 six years ago. *In re Sentinel Management Group, Inc.*, 728 F.3d 660, 666 (7th Cir. 2013) ("*Sentinel III*").

The Seventh Circuit in *Sentinel III* had held that the debtor investment manager's "failure to keep client funds properly segregated" and its later 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. *Id.* at 668, 670-72. Reversing and remanding the case to the district court for further litigation over the bank's asserted "good faith" defense because of "inconsistencies" in that court's *Sentinel I* decision, 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

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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), available at http://bit.ly/1LWBDhI.

When remanding, 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." *Id*. at 668 n.2. The Seventh Circuit in *Sentinel III* 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*, purportedly clarifying its prior *Sentinel I* opinion, held that the bank's "good faith" insulated it under Code Section 548(c) from liability. It also held that the bank had not engaged in "egregious conduct" sufficient to subordinate its lien on equitable grounds. Conceding the debtor's "actual intent to defraud [its creditors]," the district court in *Sentinel IV* still upheld the bank's good-faith defense in accepting the pledge of customer securities. *Id*. at *8.

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." Sentinel further "represented that it would maintain customer funds in segregated accounts as required under the Commodity Exchange Act." 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.'" 728 F.3d at 662-63. It "maintained segregated accounts [with] assets that could not be subject to any [lender's] lien." The bank 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 e-mailed 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 $300 MM?" 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 bank $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 allegedly "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*.

Sentinel V
No Good Faith

The Seventh Circuit criticized the district court "on remand" for its failure to "conduct an evidentiary hearing" or make "additional findings." 2016 WL 98601 at *2. More important, the district court misunderstood "the [bank's] inquiry notice." *Id*. As the Seventh Circuit explained, because it had "inquiry notice," the bank could not have "been acting in good faith." *Id*. at *1. "The term ["inquiry notice"] signifies awareness of suspicious facts that would have led a reasonable firm, acting diligently, to investigate further and by doing so discover wrongdoing." *Id*., citing *In re M&L Business Machine Co.*, 84 F.3d 1330, 1335-38 (10th Cir. 1996) ("measured objectively"; "if … reasonable person on inquiry of a debtor's fraudulent purpose, and a diligent inquiry would have discovered … fraudulent purpose, then … transfer is fraudulent"; good-faith defense rejected); *Warfield v. Byron*, 436 F.3d 551,560 (5th Cir. 2006) (same); *In re Sherman*, 67 F.3d 1348, 1355 (8th Cir. 1995) (same); and *In re Agricultural Research & Technology Group, Inc.*, 916 F.2d 528, 535-36 (9th Cir. 1990). In other words, "inquiry notice is not knowledge of fraud or other wrongdoing, but merely knowledge that would lead a reasonable, law-abiding person to inquire further — would make him … suspicious enough to conduct a diligence search for possible dirt." 2016 WL 98601, at *2.

The defendant bank had, as noted, documentary information (*e.g.*, financials) "that should have created the requisite suspicion." *Id*. The internal e-mails, mentioned above, placed "the bank on inquiry notice and thus require[d] it to conduct an investigation of what Sentinel was using to secure a $300 million debt when it had capital of no more than $3 million." *Id*.

According to the court, the bank had "more than enough" notice of a possible fraud so as to require it to "investigate." *Id*. at *3. Indeed, "all that is required to trigger" the duty to investigate was "information that would cause a reasonable person to be suspicious enough to investigate." *Id*. The Seventh Circuit stressed that the district court's fact findings in its original 2010 opinion (*Sentinel I*) "actually prove inquiry notice." *Id*. at *4.

No Equitable Subordination

The court of appeals affirmed the district court's holding that the trustee had not proved the defendant bank's knowledge of Sentinel's "securing the bank's loans with customers' money without their consent." *Id*. at *6. "Even though the bank's secured claim [went] down the drain because it was on inquiry notice of Sentinel's fraud, it still has an unsecured claim in bankruptcy — a claim for the money it lost when Sentinel failed to repay the bank's loan to it of $312 million." *Id*. at *4-5. According to the court, "the defendant's conduct must be not only 'inequitable' but seriously so ('egregious,' 'tantamount to fraud,' and 'willful' are the most common terms employed) and must harm other creditors." *Id*. at *5, citing *Carhart v. Carhart-Halaska Int'l, LLC*, 788 F.3d 687, 692 (7th Cir. 2015).

Although other creditors had been "harmed by the bank's accepting the accounts of Sentinel's customers as security for its loan," that was not tantamount to fraud. The court agreed "with the district judge that the trustee has not satisfied that high standard. To suspect potential wrongdoing yet not bother to seek confirmation of one's suspicion is negligent, and negligence has not been thought an adequate basis for imposing equitable subordination." The bank had suspicions and should have followed up, but it was merely negligent. *See generally*, A.S. Lurey, Bankruptcy Lit. Manual, § 8.02(B), at 8-13 (2015-16 rev. ed.) ("If the claimant is a non-insider, egregious misconduct must be proven with particularity. Sharp dealing will not suffice; rather, … conduct involving moral turpitude, such as fraud," must be proved.).

Bank Retains Unsecured Claim

Finally, the court rejected two other defenses raised by the bank "to losing its status as a secured creditor." Although Code Section 550(b)(1) provides a defense to a lender who "gave value for the transfer in good faith," that provision was inapplicable, for the trustee did not seek to recover assets, but only to avoid the bank's lien. Nor was the trustee seeking "a double recovery"; the bank was "still owed Sentinel's debt to it. It has just lost its security interest." *Id*. at *6.

Comments

1. Rescue lending is still alive despite *Sentinel V*. The U.S. Supreme Court's seminal *Dean v. Davis* decision, 242 U.S. 438, 444-45 (1917), confirms that an arm's-length, good-faith commercial loan will not be undone: 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 bank in *Sentinel V* lost its good-faith defense because it had inquiry notice and failed to investigate, but still accepted a third party's property as collateral.

2. The district court's failure in *Sentinel IV*, after a 17-day trial, to conduct another "evidentiary hearing" or to make "additional findings" triggered the Seventh Circuit's reversal. 2016 WL 98601, at *2. Nevertheless, "in fairness to the [district] judge," the court of appeals conceded that the panel in *Sentinel III* could have reversed *Sentinel I* "outright." *Id*. at *5. There had been "no need to remand," it reasoned, due to the district court's ample findings in *Sentinel I* that "the bank had … been on inquiry notice." *Id*.

3. Another lender successfully relied on the "good-faith" defense in the past two years. *See Gold v. First Tennessee Bank, N.A.*, 743 F.3d 423 (4th Cir. 2014) (2-1) (applying "objective good-faith standard"; bank investigated debtor before lending; when debtor offered excuses for non-payment, bank visited collateral "properties," reviewed records and understood market conditions, consistent with industry practice; bank had no "information" requiring it to "investigate further"). *See also 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: noting that "the great weight of authority holds that it is information suggesting insolvency or a 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 and 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.").

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