Lender May Lose its Liens When Put on "Inquiry Notice" Regarding a Debtor's Possible Fraud

On January 8, 2016, the U.S. Court of Appeals for the Seventh Circuit issued its opinion in the case of Grede v. Bank of New York Mellon Corp. (In re Sentinel Management Group, Inc.), No. 15-1039, in which it explained that, when a bank officer had reviewed the Debtor's loan file and became puzzled regarding the ownership of collateral pledged by the Debtor, the bank was put on "inquiry notice" which would "require that he or others at the bank investigate" a possible fraud. Id. at 3.

The Court held that the bank's failure to investigate, after it became suspicious, precluded the bank from asserting a "good faith" defense to a fraudulent transfer claim brought by the chapter 7 trustee seeking to avoid the transfers of customer assets out of segregation and into the lienable accounts (which the Debtor used as collateral for its overnight loans from the bank). Id. at 9. Although the Seventh Circuit determined that the bank's security interest in the customer funds could be avoided, the Court held that the bank's failure to follow up on its suspicions did not meet the high standard required to impose equitable subordination to the bank's claim vis-à-vis the Debtor's unsecured creditors. Id. at 11.

BACKGROUND FACTS

Sentinel Management Group, Inc. (the "Debtor") was a cash management firm that invested cash, which had been lent it by persons or firms, in liquid low-risk securities. Id. at 2. The Debtor also traded on its own account, using money borrowed from Bank of New York Mellon Corp. and Bank of New York ("BNYM") to finance the trades. Id. BNYM required that its loans be secured. Id. However, because the Debtor did not own enough assets to provide the required security, the Debtor pledged securities that it had bought for its customers with their own money, even though its loans from BNYM were used for trading on its own account.[1]

In August 2007, when the securities markets became shaky (just before the 2008 financial crash), the Debtor experienced trading losses that prevented it from maintaining its collateral with BNYM and meeting the demands of its customers for redemption of the securities it purchased with their assets. Id. The Debtor used its line of credit with BNYM to meet those demands. Id.

By June 2007, the Debtor's loan balance with BNYM was $573 million; two months later it halted redemptions to its customers and declared bankruptcy, owing BNYM $312 million. Id. The bankruptcy trustee (the "Trustee") believed that the liquidation of the bank's collateral would deny the Debtor's customers more than $500 million in redemptions. Id. at 3. The Trustee refused to classify the bank as a senior secured creditor with respect to the $312 million that the Debtor owed it. Id. The Trustee asserted a claim that the transfers of customer assets to accounts that the Debtor could (and did) use to collateralize its loans from BNYM were fraudulent transfers under 11 U.S.C. § 548(a)(1)(A). Id.

[1]Federal law (7 U.S.C. §§ 6d(a)(2), 6d(b)), as well as the contracts between the Debtor and its customers, required that the securities of customers be held in segregated accounts that were kept separate from the Debtor's own assets. See id. Therefore, the Debtor was forbidden to pledge the assets in the segregated accounts to BNYM as security for BNYM's loans to it. Id.

THE COURT'S DECISION

The Court stated that, "[t]he bank would have been in the clear had it accepted the pledge of the assets "in good faith" (which is a defense under 11 U.S.C. § 548(c)), but it would not have been acting in good faith had it had what's called 'inquiry notice'." Id. The Court explained that "inquiry notice" is a term that "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); In re Sherman, 67 F.3d 1348, 1355 (8th Cir. 1995); In re Agricultural Research & Technology Group, Inc., 916 F.2d 528, 535–36 (9th Cir. 1990)). The Trustee believed that officials of BNYM had been aware of suspicious facts that should have led them to investigate, and that an investigation would have revealed that the bank could, not in good faith, accept assets of the Debtor's customers as security for the bank's loans to the Debtor. Id.

The Seventh Circuit noted that, in earlier proceedings, a U.S. District Judge had conducted a 17-day bench trial that convinced him that the Debtor was in the clear—that the Debtor did not intend to defraud its customers, in violation of 11 U.S.C. § 548(a)(1)(A), when it transferred their segregated funds into clearing accounts, where they became collateral for the BNYM's loans to the Debtor—and dismissed the trustee's claim against the bank. Id. at 3-4. However, an earlier panel of the Seventh Circuit had reversed the District Court, holding that the Debtor had made fraudulent transfers and instructing the District Judge to decide on remand *whether BNYM had been on inquiry notice in its dealings with Sentinel*. Id. at 4. On remand, the District Judge issued a "supplemental opinion" intended merely to clarify his prior opinion and findings of fact. Id.

The Seventh Circuit explained:

> The supplemental opinion reveals a misunderstanding of the concept of inquiry notice. The opinion suggests that the bank, as long as it did not believe that Sentinel had pledged customers' assets to secure its loans without the customers' permission, was entitled to accept that security for its loans without any investigation. That's incorrect, because **inquiry notice is not knowledge of fraud or other wrongdoing but merely knowledge that would lead a reasonable, lawabiding person to inquire further—would make him in other words suspicious enough to conduct a diligent search for possible dirt**.

Id. (emphasis added).

The Seventh Circuit explained that, the bank's information that should have created the requisite suspicion was illustrated by an e-mail from a bank officer that responded to another bank employee's e-mail regarding the collateral as follows: "How can they [i.e., Sentinel] have so much collateral? With less than $20MM [i.e., 20 million dollars] in capital **I have to assume most of this collateral is for somebody else's benefit. Do we really have rights on the whole $300MM?**" (emphasis added)

The Seventh Circuit concluded that the "somebody else" referred to in the e-mail was "an obvious reference to Sentinel's customers, owners of the accounts held by Sentinel; it was their money that was being used—improperly—to secure the bank's loans to Sentinel." Id. at 5. The Court explained that the bank officer's puzzlement was enough, given his position in the bank, to place the bank on "inquiry notice" and, thus, require 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.

In the second half of its opinion, the Seventh Circuit examined whether the bank's conduct was sufficient to justify the imposition of equitable subordination of its claim under 11 U.S.C. § 510(c)(1). Id. at 10. The Court explained that "there is general agreement in the case law that 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. (citing Carhart v. Carhart-Halaska Int'l, LLC, 788 F.3d 687, 692 (7th Cir. 2015); In re Kreisler, 546 F.3d 863, 866 (7th Cir. 2008); In re Granite Partners, L.P., 210 B.R. 508, 515 (Bankr. S.D.N.Y. 1997)).

The Court held that, although the actions of the bank did harm creditors, in order to be tantamount to fraud, it "would require that the bank believed there was a high probability of fraud and acted deliberately to avoid confirming its suspicion." Id. at 11 (citing Global-Tech Appliances, Inc. v. SEB S.A., 131 S. Ct. 2060, 2070–71 (2011)). The Seventh Circuit agreed with the District Court that the Trustee did not satisfy that high standard in this case. Id. The Court explained that, "[t]o 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." Id. (citing In re Franklin Bank Corp., 526 B.R. 527, 534 (D. Del. 2014)).

CONCLUSION

The *Sentinel* decision is a reminder for lenders to be diligent in investigating their borrowers, and to not rely on borrowers' representations and assurances regarding the value and extent of their assets or the conduct of their business.

# # #

This Client Alert was prepared by Johnathan C. Bolton (jbolton@goodsill.com or (808) 547-5854) of Goodsill's Creditors' Rights and Bankruptcy Practice Group.

Creditors' Rights and Bankruptcy. Goodsill's attorneys practicing in the area of creditors' rights and bankruptcy concentrate on the representation of creditors, trustees, committees and other interestholders in complex bankruptcy, foreclosure and receivership matters, commercial landlord-tenant matters and major collections matters. Goodsill attorneys are adept at helping creditors avoid protracted litigation through creative workouts and settlements. Goodsill attorneys in this practice area frequently contribute to publications and lecture at bankruptcy and collection law seminars.