CLIENT MEMORANDUM

Banks Forfeit Pledged Collateral Due to Their Failure to Investigate Warning Signs of Borrower's Misconduct

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The 7th Circuit Court of Appeals has held that once a lender is on "inquiry notice" of a borrower's potential improprieties in pledging collateral, the lender must take diligent steps to investigate or potentially lose its collateral.[1] That is because the existence of inquiry notice precludes the lender from utilizing good faith as a defense to a fraudulent transfer action seeking to avoid a borrower's improper pledge of collateral. Critically, the 7th Circuit adopts the low threshold generally used to trigger inquiry notice: A lender need not know of or purposely avoid investigating a borrower's misconduct. Instead, all that is required is that the lender have knowledge sufficient to make a reasonable, law-abiding person suspicious enough to inquire further.

The 7th Circuit's Sentinel Decision

Sentinel had two business lines. First, it invested cash that customers loaned to Sentinel in low-risk securities. Federal law and applicable contracts required Sentinel to place those securities in segregated accounts separate from Sentinel's assets and prohibited Sentinel from pledging those securities to secure loans to Sentinel. Second, Sentinel traded for its own account primarily using proceeds from bank loans.

1 In re Sentinel Management Group, Inc. (Grede v. Bank of New York Mellon Corp.), 809 F.2d 958 (7th Cir. Jan. 8, 2016).

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Despite the legal and contractual prohibitions regarding customer assets, Sentinel pledged customer securities to secure the bank loans that funded Sentinel's trading for its own account. As the securities markets began faltering, Sentinel then drew on its bank lines of credit to meet customer redemption demands. Once Sentinel could not maintain adequate collateral to secure its bank loans and continue to honor customer redemption requests, Sentinel sought chapter 11 protection.

In Sentinel's bankruptcy case, the banks sought to liquidate the collateral pledged to fully secure their $312 million of outstanding loans. In response, Sentinel's bankruptcy trustee challenged the banks' security interests by arguing Sentinel's transfers of customer securities to accounts collateralizing the banks' loans were fraudulent transfers under Bankruptcy Code section 548(a)(1)(A). Specifically, the trustee contended those transfers were made by Sentinel "with actual intent to hinder, delay, or defraud another creditor." The banks' defense, under Bankruptcy Code section 548(c), was that they received the asset pledges in "good faith."

The 7th Circuit held the banks could not have acted in good faith if they had "inquiry notice" of problems with the pledges of collateral. Specifically, the 7th Circuit held that 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." (In contrast, the trial court had held that inquiry notice required the banks to have actual knowledge of fraud or other wrongdoing and absent a belief that the collateral was improperly pledged, the banks could accept security for their loans without any investigation.) Moreover, the 7th Circuit emphasized that "mere negligence" was sufficient to preclude good faith; the banks need not actually have known of or refused to investigate the impropriety for fear of uncovering it.[2] The 7th Circuit reasoned that inquiry notice did not require the banks to know or believe the collateral was improperly pledged, but merely to have knowledge sufficient to raise a suspicion in "a reasonable person" and require an investigation.

The 7th Circuit found that the Sentinel banks must have had the requisite suspicion based primarily on a senior bank manager's memo to other bank employees working on the Sentinel account. In the memo, the manager questioned how Sentinel could have posted hundreds of millions of dollars of collateral while having only a few million dollars of capital and, therefore, whether "most of its collateral is for someone else's benefit" (i.e., Sentinel's customers). The bank manager's memo received no meaningful response and the banks made no further inquiry. The 7th Circuit also noted that awareness by other bank employees on the Sentinel account of the same facts meant they also should have known there was a problem with Sentinel's pledge of collateral. Additionally, the 7th Circuit found that an investigation by the banks would have uncovered the improprieties because notwithstanding Sentinel's assurances that it had authorization to pledge customer securities, documents in the banks' possession provided otherwise.

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[2] Notably, this distinction between the banks' mere negligence or ineptitude – in contrast to actual knowledge of or "turning a blind eye" to the misconduct – led the 7th Circuit to hold the banks' conduct was not sufficiently egregious or inequitable to warrant the additional penalty of equitably subordinating (i.e., reducing the priority of) the banks' claims below the priority of general unsecured claims pursuant to Bankruptcy Code section 510(c)(1).

Analysis and Implications of Sentinel Decision

The Sentinel decision raises several questions. First, none of the 7th Circuit's or the trial court's multiple decisions explain how Sentinel's transfers of customer property (i.e., securities held in a segregated account) into the banks' collateral account could have been transfers of "an interest of the debtor [i.e., Sentinel] in property" that is required for a fraudulent transfer under section 548 of the Bankruptcy Code. Perhaps Sentinel had previously obtained title to customer assets by co-mingling them with Sentinel's assets or because the customers loaned Sentinel the funds used to acquire securities, but if true, those facts are ambiguous or unstated in the opinions. Instead, Sentinel's property interest in the customers' pledged securities is merely assumed. Second, it is unclear whether the banks would have been in any better position regarding their security interests had the banks acted on their inquiry notice. In effect, if, as the 7th Circuit suggests, any bank acting reasonably would have suspected the collateral pledge was improper and discovered that impropriety upon making a diligent investigation, then the banks would still not have obtained a valid pledge of the securities as collateral. At best, the banks might have caught the problem early enough to have prevented or minimized the amount of their unrepaid loans. (Yet, even that seems unlikely as the inquiry notice is premised largely on the magnitude of the banks' loans relative to Sentinel's capital.) Third, the 7th Circuit does not factor into its opinion the fact that a substantial portion of the banks' loans was used to honor customer redemption requests and to reduce Sentinel's liabilities, which arguably should have provided the banks with some protection.

Regardless, the key lesson of Sentinel is that lenders (and likely all major creditors) must be cognizant of and follow up on red flags warning of borrower improprieties. Otherwise, a lender's failure to heed inquiry notice could severely harm the lender's claim and collateral position.

If you have any questions regarding this memorandum, please contact Alan J. Lipkin (212-728-8240; alipkin@willkie.com) or the Willkie attorney with whom you regularly work.

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