SQUIRE PATTON BOGGS

Seventh Circuit Warns Banks: Ignore Red Flags at Your Own Peril

When can a bank be at risk of unknowingly receiving a fraudulent transfer? How much information does a bank need to have before it is on "inquiry notice"? A recent decision from the Seventh Circuit Court of Appeals highlights the risks that a bank takes when it ignores red flags and fails to investigate. This decision should be required reading for all lenders since, in the matter before the Seventh Circuit, the banks' failure to investigate their borrower's questionable activity caused the banks to lose their security and have their secured loans reduced to unsecured claims.

In re Sentinel Management Group – The Decision

Sentinel Management Group (Sentinel) was a cash-management firm that invested cash, lent to it by its customers, in liquid low-risk securities. Sentinel also traded on its own account, using money that it borrowed from two financial institutions (collectively, the "Banks"). As collateral for its loans from the Banks, Sentinel pledged securities that it had purchased for its customers using the customers' own money. Sentinel's use of its customer's securities as collateral for its own loans violated federal law and Sentinel's contracts with its own customers.

In 2007, Sentinel filed Chapter 11 bankruptcy. The Banks asserted a secured claim in the amount of US$312 million. When the Banks notified the chapter 11 trustee that they intended to liquidate the collateral that Sentinel had pledged to secure the loans, the trustee instituted an adversary proceeding alleging that the transfer of the customers' securities to the Banks constituted a fraudulent transfer pursuant to section 548(a)(1)(A) of the Bankruptcy Code. Specifically, the trustee alleged that the transfer of the securities to the Banks was made by Sentinel with intent to hinder, delay and defraud its current or future creditors.

After a 17-day trial, the district court judge ruled that Sentinel did not intend to defraud its creditors. On appeal, the Seventh Circuit reversed (*In re Sentinel Management Group, Inc.*, Case No. 15-1039 (7th Cir. Jan. 8, 2016)), and directed the district court to determine whether the Banks had been on inquiry notice in their dealings with Sentinel. In an unusual move, the district court judge neither took further evidence nor made any additional findings of fact. Instead, the district court judge simply issued a "supplemental opinion" which clarified his earlier ruling that as long as the Banks did not believe that Sentinel had pledged the customers' securities without the customers' permission, the Banks were entitled to accept the securities without any investigation.

The Seventh Circuit rejected the district court's narrow definition of inquiry notice. In a pointed opinion, Judge Richard Posner highlighted the difference between actual and inquiry notice. It was not enough that the Banks did not believe that Sentinel had acted improperly when it pledged its customers' securities as collateral for Sentinel's own loan from the Banks. Instead, the question that the district court should have asked was whether the Banks had knowledge that would lead a reasonable, law-abiding person to inquire further. In other words, did the Banks have knowledge that would make a reasonable person "suspicious enough to conduct a diligent search for possible dirt." *Id.* at 4.

Reviewing the record, the Court keyed on an internal note from a managing director of the Banks questioning how Sentinel could post over US$300 million in collateral given that it had less than US$20 million in capital, and asking whether Sentinel had rights to the entire US$300 million pledged. Standing alone, the managing director's suspicion was enough to put the Banks on inquiry notice since "all that is required to trigger [inquiry notice] is information that would cause a *reasonable* person to be suspicious enough to investigate." *Id.* at 5-6. Moreover, it did not matter that an investigation by the Banks might have been fruitless because the Banks "believed, even to [their] own detriment, the lies" told by Sentinel's CEO. *Id.* at 6. Instead, it was enough that the managing director had a reason to disbelieve Sentinel. This suspicion put the Banks on inquiry notice. Because the Banks had failed to investigate, the Court voided the Banks' liens as fraudulent transfers, therefore leaving the Banks with unsecured claims.

Nonetheless, in a win for the Banks, the Seventh Circuit held that having sufficient knowledge for inquiry notice was not enough to justify equitably subordinating the Bank's claim pursuant to section 510(c)(1) of the Bankruptcy Code. In order for a claim to be equitably subordinated, the claimant's conduct "must be not only inequitable but seriously so." *Id.* at 10. The acts must be egregious, tantamount to fraud, or willful, and must harm other creditors. *Id.* Here, the Banks merely suspected wrongdoing, and then took no action to investigate. This, the court held, was negligence, and negligence is not sufficient for equitable subordination.

Implications

The *Sentinel Management* decision should serve as a wake-up call to banks that they have affirmative obligations to investigate loan transactions when they see possible red flags. Banks have an obligation to file suspicious activity reports when they have knowledge of suspected criminal offenses or activities at or around specific monetary thresholds. Similarly, the *Sentinel Management* decision makes clear that banks have an obligation to make an inquiry when they are aware of facts that call into question the legitimacy of a loan transaction, including the pledging of collateral.

Moreover, the threshold for inquiry notice is dramatically low. All that is required is that the bank had knowledge that would lead a reasonable, law-abiding person to inquire further. Actual notice of fraud is not required. Instead, all that is needed is knowledge that would make a reasonable person "suspicious enough to conduct a diligent search for possible dirt."

The downside of failing to investigate can be draconian. In *Sentinel Management*, the Banks lost their security and were left with an unsecured claim. They are likely to receive pennies on the dollar. Therefore, banks must ensure that they have systems in place that would alert them to questionable loan transactions. Moreover, these systems should ensure that once concerns are raised, a bank conducts a diligent review of the questionable activates. Otherwise, the bank could find itself out of the money.

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