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The Impact of Rising Interest Rates and the Need for Increased Restructuring Activity

The New Wall of Debt

By David Bulley

Accommodative monetary policies over the last eight years have extended key refinancing hotspots from 2012-2015 to 2018-2021. With the Federal Reserve having now marked the end of such policies in the United States, a new and, to some extent, necessary wave of restructurings can be expected in the short and medium term.

Following the onset of the 2008 financial crisis, a wave of restructurings was expected as deteriorating market conditions impacted the already stressed balance sheets of companies. The period of 2012-2015 was expected to be the peak for restructuring activity, as pre-crisis LBO and M&A debt (the so called "wall of debt") came up to maturity. Instead, throughout the crisis years, restructuring and insolvency activity has remained generally low as central bank policies and open capital markets, particularly in the U.S., provided companies with easy and affordable access to capital.

Now, following the Federal Reserve decision in December 2015 to raise interest rates for the first time in eight years, it appears that it has embarked on the slow unwind of its zero–interest-rate policy. Against this backdrop we have also witnessed a reduction in quantitative easing in the U.S., a slowdown in China and increased geo-political tensions in the Middle East, which have resulted in a painful correction in world equity markets. In the UK alone, there has been a marked increase in profits warnings — 100 warnings were issued in Q4 2015, which is the highest quarterly total since 2009.

With restructuring activity already prevalent in the oil and gas sector and the commodities space in Europe, Africa, Asia and the Americas, the prevailing view is that the actions of governments and central banks during the crisis have not

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Seventh Circuit Voids Lien-Securing Rescue Loan

Rejects Equitable Subordination Claim

By Michael L. Cook

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

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Restructuring

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prevented the need for restructuring activity, but as mentioned above, have simply extended previous restructuring hotspots from 2012-2015 to 2018-2021. Therefore, as a number of deals reach their 2015 maturities and slowly evolve toward 2018 maturities, the less benign government economic policies and macroeconomic environment will increase the propensity for over-leveraged corporates to finally be forced into a substantive restructuring process

Recession Restructurings And the Role of the Central Banks

Restructuring and insolvency plays a vital role in the functioning of a healthy economy by removing market inefficiencies, forcing redeployments of capital and labor to more productive activities and, as a result, creating space and opportunities for new participants. However, following the 2008 financial crisis, the benign credit environment created by central bank actions, namely reducing interest rates to near zero, undertaking quantitative easing and providing financial bailouts, negated the need for many over-leveraged corporates to address their balance-sheet positions, as they were able to refinance their debt in the low–interest-rate environment and continue to service their debt.

Non-performing companies were further aided by new bank capital regulations that encouraged banks to allow non-performing companies to refinance or amend and extend their debt, allowing banks to carry such debt on their balance sheets as performing assets rather than having to accelerate the debt and take balance-sheet write-downs. Further, where banks were not willing to refinance or amend and extend debt, distressed credit investors and, particularly, the high-yield market, gave companies access to credit and broke any log-jam in bank financing. The wall of debt was thereby scaled, but it was largely achieved by the re-characterisation of loans as performing assets or by substituted credit.

As a consequence, economies around the world have failed to clear the "deadwood" or "zombie" companies, which in previous recessions would have been restructured or forced into insolvency, resulting in inefficient allocations of resources. This may partly explain why the growth rate in U.S. output exiting the global financial crisis has been the lowest following any of the 11 post-World War II recessions.

A further unintended consequence of accommodative monetary policy during the financial crisis has been the growth in overseas borrowers and issuers accessing cheap U.S. dollar-denominated capital through the bank and bond markets, which has then been invested in higher yielding local assets in a form of corporate carry-trade. As monetary policy in the U.S. is unwound and interest rates rise, many of the corporates that have taken such funding, but failed to hedge against Foreign Exchange (FX) and interest-rate risks on their floating-rate debt are more likely to become distressed.

The Impact of Rising U.S. Interest Rates On Restructurings

According to a dot graph issued in December 2015, Fed officials expect the federal funds rate to be increased gradually with the rate being 1.375% at the end of 2016, 2.375% at the end of 2017 and 3.25% at the end of 2018.

The impact of such rises must be considered in both the short term, 2016-2017, and the medium term, 2018-2021 — the period during which the "new wall of debt" of

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CT Bankruptcy Court Invalidates Lawsuit Funding Agreement

By John B. Spitzer

Lawsuit funding companies have routinely filed claims as creditors in tort plaintiffs' bankruptcy actions when the debtor has failed to repay litigation funding advances. Whether bankruptcy courts will enforce lawsuit funding agreements depends on the applicable state law.

Creditors should take note of recent cases invalidating or upholding state regulation of lawsuit funding agreements. For example, in *Global Injury Funding, LLC v. Knight* (*In re Knight*), 538 B.R. 191 (Bankr. Conn. 2015), a bankruptcy judge in Connecticut recently invalidated a lawsuit funding agreement. The court focused on the applicable state law in rejecting the lawsuit funding company's (Global) attempt to enforce the following provision of its agreement with Jesse K. Knight, a personal injury claimant, to whom it had advanced funds:

> Purchaser's interest [is] to be described as an asset of Purchaser (and not as a debt obligation of Claimant in any oral or written communications, including, but not limited to, any schedule or other document filed in connection with said case or proceeding. Claimant agrees, absolutely, irrevocably and without condition, to notify the Bankruptcy court and/or other relevant court that Purchaser owns a portion of any potential recovery from said claim and Purchaser is entitled to notify the court of the same. Accordingly, in light of the fact that the funds advanced herein by Claimant are an investment and not a loan, Claimant's obligation will not be discharged or reduced as a result of any Bankruptcy or Insolvency proceeding.

Id. at 199

Rejecting these agreement terms, the court held that Global's advance to the debtor created a debt that was subject to the debtor's discharge in the bankruptcy case, and any assignment of the personal injury proceeds arising under the agreement was unenforceable.

The court also held that Global had no equitable lien on the proceeds because Connecticut law did not provide for such liens. The court said that the bankruptcy trustee could assert a claim to the proceeds of the personal injury lawsuit and that the court would determine what rights the estate had in those proceeds at a later time.

Knight obtained funds from Global in anticipation of Knight's recovery through a settlement or award in a pending state court personal injury action. The agreement obligated Knight to repay Global a sum, plus fees from settlement or award proceeds.

Nondischargeability

The court held that Global failed to establish by a preponderance of the evidence many of the requisite elements for a determination of nondischargeability pursuant to § 523(a)(2)(B). Quoting *Grogan v. Garner*, 498 U.S. 279, 286-87, 111 S. Ct. 654 (1991) and other key cases, the court said that a determination of nondischargeability requires the plaintiff to establish each of the elements for a nondischargeability determination as enumerated in § 523(a)(2)(B). The court focused on the elements that Global Injury Funding failed to establish.

Regarding the first element, which requires the Plaintiff to establish that the statements were materially false, the court said that Knight's statement that he had not filed bankruptcy within the past seven years or consulted attorneys concerning filing bankruptcy was false.

But the court also found, regarding the next element — materiality — that Knight's statement was not material. Quoting *Bethpage Federal Credit Union v. Furio* (*In re Furio*), 77 F.3d 622, 624 (2d Cir. 1996) for the proposition that a statement must be both false and materially false, the court concluded that Knight's false statements about his past bankruptcy filings did not affect Global's decision to grant credit to Knight.

Global also failed to meet a third required element of § 523(a)(2)(B), which required it to establish that the statements reflected the financial condition of Knight or related to the financial condition of Knight. The court said that there is disagreement concerning whether a statement of financial condition is limited to a specific type of financial statement that purports to represent a person's overall net worth or a person's overall ability to generate income, or extends to any written communication that has a bearing on the debtor's financial position. The court quoted *Schneiderman v. Bogdanovich* (*In re Bogdanovich*), 292 F.3d 104, 112 (2d Cir. 2002) for the proposition that courts have adopted both broad and narrow interpretations of the term "financial condition" for nondischargeability purposes.

Knight's statement that he had not filed bankruptcy within the past seven years (or consulted a bankruptcy attorney), although false, "did not inform Global concerning his assets or liabilities, his income," or his financial condition. Moreover, the court concluded that it was clear "that the singular financial issue that concerned Global was whether the personal injury claim held by Knight was likely to bring a financial recovery sufficient to enable Knight to repay" Global's advance, "plus earn it the hefty fees" specified in its agreement with Knight. The agreement provided that the only source of recovery for the advance was the proceeds of the personal injury action. The court concluded that the "potential for a recovery by Global of the Advance, the interest due thereon, and payment of additional fees, was not in any way dependent

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Lawsuit Funding

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upon Knight's own financial ability to repay the Advance."

Finding that Knight's false statements were not statements respecting the Debtor's financial condition, the court held that Global was not entitled to a determination of nondischargeability pursuant to § 523(a)(2)(B).

Reasonable Reliance

The court also found that Global failed to establish the reasonable reliance element of § 523(a)(2)(B). Stating that a creditor's reasonableness should be judged objectively, the court said that Global failed to establish that in advancing funds to Knight, it reasonably relied on Knight's statements. The court found authority for the proposition that partial creditor reliance on the debtor's representations as a contributing factor is sufficient to create debtor liability to the creditor (discussing and quoting *Barristers Abstract Corp. v. Caulfield* (*In re Caulfield*), 192 B.R. 808, 821 (Bankr. E.D.N.Y. 1996)).

The court said that Global presented no evidence that Knight's disclosure of bankruptcies "would have resulted in Global walking away from the Agreement." No evidence established whether Global would have rejected Knight's application for funds if Global had known of the bankruptcies, the court found.

CO Supreme Court Approves Funding Agreement Regulation

Courts in Colorado have also held that these lawsuit funding agreements create loans that are debts in bankruptcy proceedings. Rejecting the lawsuit funding companies' characterization of their advances as "asset purchases," the Colorado Supreme Court recently held that lawsuit funding loans are subject to Colorado's consumer finance statutes. *Oasis Legal Finance Group, LLC v. Coffman*, 2015 C.O. 63 (Colo. 2015).

The Colorado Supreme Court said in *Oasis* that the funding agreements created debt for purposes of Colorado's Uniform Consumer Credit Code, even though the agreements did not impose an unconditional obligation on personal injury claimants to repay the funders.

The court found that the funding agreement obligations increased "with the passage of time, another characteristic of a loan." The litigation funders required claimants to repay more than the amount advanced and the agreements correlated the amount of the claimants' repayments to the time the advances were outstanding:

> Oasis denominates this rate of increase a "multiplier" while LawCash calls it a "monthly use fee," but in both cases the charges function as interest. This growth in the repayment obligation over time is a finance charge and a hallmark of a consumer loan under the UCCC.

Funding Agreement Enforced Under NJ Law

Under New Jersey law, however, lawsuit funding agreements like those in *Knight* and *Coffman* are enforceable. *In re Brown*, 34 B.R. 100 (Bankr. N.D. W. Va. 2006) (applying New Jersey law). The *Brown* court held that the lawsuit funding agreement in that bankruptcy proceeding met the three statutory requirements necessary for a valid assignment — The agreement: 1) provided that the debtor transfer to Atlas Legal Funding his right to receive a portion of any settlement proceeds that he would be entitled to receive in the future from his personal injury claim in exchange for a cash payment from Atlas Legal Funding; 2) set forth a description of what was assigned — in this case contingent settlement proceeds; and 3) made the assignment irrevocable.

The lawsuit funding agreement gave the debtor a five day "cooling off" cancellation period. The court held that this contingency did not change the irrevocable nature of the assignment itself after the expiration of that five-day period.

The *Brown* court also held that, in a bankruptcy proceeding, the transfer of a cause of action originally belonging to the debtors back to the debtors in consideration for a payment of money to their bankruptcy estate did not violate any state public policy prohibition against champerty or maintenance.

Conclusion

There are three key takeaways from these cases: Creditors evaluating the enforceability of a lawsuit funding agreement must: 1) review the agreement's choice of law provision to determine which state's law applies to the agreement; 2) determine if the bankruptcy court is likely to defer to the parties' agreement concerning the applicable state law and their interpretation of those provisions; and 3) determine whether the applicable state's statutes, rules of professional responsibility, or common law doctrines of champerty and maintenance have been interpreted to make those agreements unenforceable.

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Wall of Debt

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approximately USD $1.2 trillion of low-interest rate speculative grade debt, which was refinanced between 2012 and 2015, comes up for maturity. In addition, distinctions must be drawn between the impact on U.S. companies and those overseas companies with U.S. dollar-denominated debt.

Short-Term Impacts: U.S. Companies

Anecdotally, while restructuring activity in the U.S. in Q1, 2016, has increased, it is still perceived to be unlikely to pick up significantly in most sectors in the short term. The commodity and oil and gas sectors are the one variable that will see rising levels of restructuring activity driven primarily by low commodity prices and macro and geo-political forces in these respective sectors rather than by interest rate rises. First, interest rate rises will only impact debt service costs on floating rate debt or any debt that comes

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up for maturity during this period, which is insignificant compared with the debt maturing in the medium term. Further, the interest rate of 2.375% expected by the end of 2017 is still low by historical standards and less than half of the interest rate in June 2007, which stood at 5.25%.

Short-Term Impacts: Overseas Companies

In contrast, restructuring activity can be expected to increase significantly in 2016 and 2017 for overseas companies, particularly in the emerging markets, most notably Brazil, India and Indonesia. While rising interest rates will, once again, only directly impact floating rate debt service costs in an insignificant manner, restructuring activity will be driven by worsening currency mismatch risk for corporations with local currency revenues, an insufficient hedging of FX and interest rate risks.

As U.S. interest rates increase, a repatriation of dollars into higher yielding U.S. investments will cause the U.S. dollar to continue its appreciation against foreign currencies, particularly against emerging market currencies, many of which have already been negatively impacted by the flight to safety following the recent collapse in commodity prices. This will increase the cost of servicing U.S. dollar-denominated debt in local currency terms, further stressing balance sheets and necessitating restructuring activity.

Brazil, India and Indonesia in particular are prime restructuring hotspots due to only approximately 50% of foreign currency debt in India being hedged, with similar rates of hedging in Brazil and Indonesia (some of the lowest rates of hedging globally). In fact, the impact of currency mismatch risk has already been seen in Indonesia, where PT Gajah Tunggal Tbk was downgraded with Moody's citing, among other things, its "largely unmitigated exposure to a weakening Rupiah."

In addition, as interest rates rise, China may prove to be an unexpected source of restructuring activity, particularly in the highly leveraged real-estate sector, where firms have issued approximately USD $63 billion of U.S. dollar-denominated debt, but have FX assets cover of less than 25%. Chinese firms have also been reluctant to hedge currency risks due to the pegging of the yuan to the U.S. dollar and the expectation that the cost of hedging (around 3.7% in December 2015) would be more costly than the protection provided. However, following recent devaluation of the yuan by the People's Bank of China, debt service costs have increased significantly and it appears that further devaluation of the yuan will be allowed as the U.S. dollar strengthens further increasing local currency debt service costs and stressing the balance sheets of riskier lower-rated, highly leveraged Chinese firms.

These factors have led to concerns regarding the potential non-performing nature of Chinese loans. Current official data in China shows non-performing loans at 1.59% of outstanding credit (approximately RMB ¥1.2 trillion or USD $187 billion). However, if "Special Mention" loans are included, that brings the percentage of loans where repayment is at risk to 5.4% — low in historical comparison, but to put this into perspective, a 5.4% effective NPL rate is about RMB ¥4 trillion (or USD $628 billion). This equates to an amount slightly larger than the size of Sweden's GDP, and more than twice the entire size of Greece's economy.

Medium-Term Impacts: U.S. Companies

In the medium term, restructuring activity in the U.S. can be expected to accelerate rapidly as capital access and affordability declines due to rising interest rates and increased competition for capital.

First, as interest rates rise, high-yield investors will be less inclined to chase yield through lower-quality credit classes (a factor that allowed many speculative grade companies to refinance during the financial crisis) and instead will focus on less speculative grade companies that will provide sufficient yields for investors without the assumption of such significant default risk. This is likely to leave a whole class of the most speculative grade companies, which relied on high-yield financing to navigate the financial crisis, exposed to deeper and more substantive restructuring and insolvency risk.

Second, for those companies that have access to capital, the increased debt pricing due not only to rising interest rates but also increased competition for capital, will simply be too great for certain stressed balance sheets. As competition for capital increases, bank and bond investors will re-price insolvency risk spreads for lower-grade companies, which may overwhelm many balance sheets that are currently stressed even as debt service costs are at an all-time low.

Finally, the willingness and ability of creditors to amend and extend debt in the medium term will be reduced, removing a refinancing tool that played a vital role in the survival of many companies during the financial crisis. For banks, willingness to amend and extend debt terms relies on some future prospect of the full refinancing or repayment of the company's debt. However, where companies have existed for eight years in the lowest interest rate environment in history and still failed to refinance or de-leverage, the prospect of future refinancing or repayment in a rising interest rate environment is questionable at best.

Further, the ability of CLOs to provide capital, which again played a significant role in extending debt maturities during the financial crisis, will have been reduced as the reinvestment period for approximately 69% of original CLOs will have ended. Any reduction in the issuance levels of the CLO primary market due to regulatory changes, such as risk retention rules, or otherwise will put upward pressure on loan spreads and reduce available capital for corporates, leading to the prospect of significantly higher leveraged loan default rates when refinancing needs arise.

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Medium-Term Impacts: Overseas Companies

In the medium term, overseas companies with U.S. dollar-denominated debt will face the same credit access and pricing risks as U.S. companies and, in addition, will continue to face FX risks, which were described above. Further, where U.S. dollar-denominated funding is unavailable, local credit markets have insufficient depth to provide alternative local currency financing to refinance maturing U.S. dollar-denominated debt.

As a result, a wave of restructurings can be expected in the emerging markets, which will extend beyond those companies that are impacted in the short term, due to a lack of hedging, to all companies whose balance sheets are not sufficiently robust for a re-pricing of all of their maturing debt — or that simply lack access to capital due to local credit market depth.

One potential impact of this refinancing need in emerging markets, particularly China (where the credit (debt) to GDP ratio is expected to exceed 280% in the medium term), could be the nationalisation of corporate debt through the use of bailouts, as emerging markets seek to prevent a wave of restructurings.

The Growth Variable

One factor that could offset increased restructuring of U.S. dollar-denominated debt as U.S. interest rates rise is increased global growth. However, given the current malaise in China, Europe and Latin America, it is difficult to see where such growth will come from, absent a macro-economic shock such as war, which can provide short-term positive growth, or large changes in fiscal policy. The OECD figures support continued low growth expectations, with current predictions in global growth in 2016 and 2017 being 3.3% and 3.6% respectively (on the basis of 7% growth in China, which is looking increasingly unlikely given recent economic indicators).

Outlook

Accommodative monetary policy during the financial crisis prevented the need for widespread restructurings in the early years of the financial crisis. However, the continuation of such policies for eight years has allowed a U.S. dollar debt mountain to form, which will drive an increase in restructuring activity as maturities evolve. As a result of the unwinding of accommodative policies, restructuring activity should be expected to rise slowly in 2016 and 2017 in the U.S. and more quickly overseas, before rapidly accelerating in 2018 onwards. While such restructuring activity will prove painful for the U.S. and world economy, it is a necessary evil to force efficient resource allocation and obtain increased growth rates, and to avoid a continuation of the low-growth malaise that is currently being seen in many countries around the world.

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Rescue Loans

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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 defraud" creditors under Bankruptcy Code ("Code") Section 548(a)(1)(A). *Id*. at 666. *See* M.L. Cook, "Seventh

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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

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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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