BARACK FERRAZZANO
Financial Institutions Group

Client Alert

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Federal Appeals Court To Banks: CAUTION

Ignore Red Flags In Loan Transactions at Your Own Peril

Controlling Your Risk

Lenders should review their practices for flagging questionable loan transactions.

Avoid Becoming an Unsecured Lender

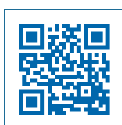
The upshot of Sentinel is that the threshold for banks to inquire into questionable loan transactions is low. Banks wishing to avoid the fate of Sentinel's now unsecured lenders should review their practices for flagging questionable loan transactions, and make sure those practices are adequate to both identify loans (especially those with volatile collateral) that should trigger an investigation, and to ensure an adequate investigation occurs.

Sentinel's Lenders Lose $300 Million in Collateral

A federal appeals court has just made it a bit riskier for banks to ignore red flags in loan transactions. Recently, the United States Court of Appeals for the Seventh Circuit issued a decision that essentially erased the value of $300 million in collateral two banks received to secure loans to the now bankrupt Sentinel Management Group. In In re Sentinel Management Group, Inc. No. 15-1039 (7th Cir. Jan. 8, 2016), the Court of Appeals ruled Sentinel's posting of collateral with a value of more than 10 times the capital it had on hand was a red flag that obligated the banks to investigate. Had they done so, the banks would have learned the securities Sentinel posted as collateral did not belong to Sentinel, but rather to Sentinel's customers. Because the banks ignored the red flag, they lost their collateral. The decision by the appeals court based in Chicago has the most direct impact on banks with customers in Illinois, Indiana and Wisconsin, but the Seventh Circuit is influential, and its ruling will likely influence courts across the country.

Facts Behind the Ruling

Sentinel was a cash management firm that invested its customers' money in low risk securities. In order to obtain cash to trade on its own account, Sentinel also borrowed money from the banks, pledging its customers' securities as collateral. That action violated both federal law and Sentinel's contracts with its customers. When Sentinel filed for bankruptcy in 2007, the banks filed a secured claim in the amount of $312 million, and notified the trustee in bankruptcy they intended to liquidate the collateral. The trustee asserted Sentinel's pledge of its customers' securities was a fraudulent transfer intended to defraud Sentinel's current and future creditors. A lengthy trial ensued, at the end of which the trial judge ruled that because the Banks did not believe Sentinel had pledged the securities without their customers' permission, the banks were entitled to accept the securities without investigation.



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The Court of Appeals reversed the trial court, focusing on a document showing that a bank officer had questioned how Sentinel could post over $300 million in collateral when it had only $20 million in capital on hand, and also whether Sentinel had rights to the entire amount it pledged. The Seventh Circuit held this information was sufficient to cause a reasonable person to be suspicious of what they had been told by Sentinel, and to investigate. Because the banks failed to do so, they lost their security interest in the collateral and were left with an unsecured claim against the bankruptcy estate.

What the Ruling Means for Banks

Importantly, the Seventh Circuit did not limit its decision to the amount of the loan or the collateral at issue, i.e. pledged securities. Thus the Court's decision could be applied to smaller loans secured by other types of collateral that fluctuate in value and composition, such as receivables and inventory in an asset based or C&I loan. For example, a bank might be put on notice if a loan is secured by receivables or inventory that are out of proportion to the borrower's size and scope of operations.

We Can Help You

Please contact the attorneys listed below if you would like assistance in identifying and mitigating loan and collateral risks.

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