

Practice Update

Lenders are Required to Investigate Suspicious Loan Transactions

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By Michael L. Molinaro and Thomas B. Fullerton

The Seventh Circuit Court of Appeals recently held that a lender is obligated to conduct a diligent investigation when it becomes aware of suspicious facts relating to the legitimacy of a loan transaction. In *Sentinel Management Group, Inc.*, 2016 WL 98601 (7th Cir. January 8, 2016), the Seventh Circuit found that a bank officer's puzzlement was enough to place the bank on inquiry notice, which required the bank to investigate the collateral the borrower was using to secure the loan.

In *Sentinel*, the bank made a \$500 million loan collateralized by securities. After reviewing a collateral report, a bank officer sent an email to other bank employees inquiring whether the borrower really could have as much collateral as was listed on the report and raising the possibility that the collateral was owned by someone else. The bank officer received a nonresponsive answer to his question and made no further inquiry.

Subsequently, the borrower filed a Chapter 11 case, and a bankruptcy trustee was appointed. The trustee discovered that the borrower had pledged to the bank certain securities that were owned by customers of the borrower (i.e. not owned by the borrower). The trustee sued the bank, seeking to void the grant of the security interest to the bank as a

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fraudulent transfer. The bank raised a defense as a good faith transferee in connection with the loan transaction and the collateral pledge.

The Seventh Circuit rejected the bank's defense, finding that the bank was on inquiry notice that there was something suspicious relating to its collateral. The Seventh Circuit stated that inquiry notice is "knowledge that would lead a reasonable, law abiding person to inquire further" or in other words, knowledge that "would make him... suspicious enough to conduct a diligent search for possible dirt." Consequently, the bank's security interest was voided and \$300 million of collateral was wiped out. However, in a small victory for the bank, the Seventh Circuit refused to equitably subordinate the bank's unsecured claim, concluding that inquiry notice was not tantamount to a fraud and thus did not constitute the inequitable conduct needed for subordination.

Sentinel illustrates the consequences that can result from failure to investigate suspicious facts and other warning signs. When it has knowledge of suspicious facts or warning signs, a lender must diligently check for possible wrongdoing.

Please contact the authors for any comments or questions.

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