Nos. 10-3787, 10-3990 and 11-1123

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

FREDERICK J. GREDE, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust, Plaintiff-Appellant, v. BANK OF NEW YORK MELLON CORPORATION and BANK OF NEW YORK, Defendants-Appellees	)	Appeal from the United States District Court for the Northern District of Illinois, Eastern Division No. 1:08-cv-02582 Honorable James B. Zagel

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BRIEF OF DEFENDANTS-APPELLEES THE BANK OF NEW YORK MELLON CORPORATION AND THE BANK OF NEW YORK MELLON

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CIRCUIT RULE 26.1 DISCLOSURE STATEMENT

Appellate Court No: 10-3787, 10-3990, and 11-1123

Short Caption: Frederick Grede v. Bank of New York Mellon Corporation

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ii) list any publicly held company that owns 10% or more of the party's or amicus' stock:

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Attorney's Printed Name: Mauricio España

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Attorney's Signature:__________ Date: May 20, 2011

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4 COLLIER ON BANKRUPTCY ¶510.05 (16th ed. 2011) 33, 49, 51

JURISDICTIONAL STATEMENT

Appellant's jurisdictional statement is complete and correct regarding the relevant jurisdictional issues. However, his suggestion that the district court entered "summary judgment" in its Memorandum Opinion and Order after trial (A.22-89) is incorrect. The district court's initial docket entry inadvertently stated that "summary judgment is entered" (A.21), but the court immediately corrected that entry when advised of the error, noting that its opinion "did not resolve the claims under the provisions of Fed.R.Civ.P. 56 but did so under Fed.R.Civ.P. 52." A.90.

ISSUES PRESENTED FOR REVIEW

After an extensive trial, the district court rejected the fraudulent transfer and equitable subordination claims of plaintiff-appellant Frederick J. Grede ("Grede" or "Trustee") against defendants-appellees The Bank of New York Mellon Corporation and The Bank of New York (collectively, "BNYM" or "the Bank"). Grede now challenges Judge Zagel's detailed factual findings and credibility determinations, seeks a radical transformation of fraudulent transfer law, and proposes a judicial expansion of the extraordinary and rarely applied remedy of equitable subordination to encompass mere negligence by a non-insider. The issues presented for review are as follows:

1. Whether the district court's rejection of Grede's fraudulent transfer and equitable subordination claims, based on the application of settled law to factual findings following credibility determinations made at trial, should be affirmed.

2. Whether the court properly dismissed Grede's claim that BNYM's security interest should be voided on the ground that the underlying account agreements were illegal.

STATEMENT OF THE FACTS

Grede's Statement of Facts consists largely of assertions and inferences that the district court rejected after hearing numerous witnesses and reviewing thousands of pages of exhibits at trial. The following Statement of BNYM provides the Court with a supported factual basis for understanding the business model of Sentinel Management Group ("Sentinel"), Sentinel's relationship with BNYM from 1997-2007, the summer 2007 transfers challenged by Grede, and Sentinel's subsequent collapse, as well as the proceedings below.

A. Sentinel

Before its August 2007 bankruptcy, Sentinel was an investment manager that marketed itself as providing excellent short-term returns while maintaining liquidity. BTX216, 246. Philip Bloom founded Sentinel in 1979 "to provide for more efficient management of the investment of customer funds" by futures commission merchants ("FCMs"), which operate as commodity industry equivalents to securities industry broker-dealers. BTX1.1. FCMs often hold substantial amounts of customer funds to meet futures margin requirements, 17 C.F.R. §1.3(gg)(1), and may retain profits earned from investing those funds subject to restrictions designed to preserve liquidity. *Id.* §§1.25, 1.29. Sentinel invested customer funds for FCMs (BTX246.1, 246.16) and also offered its services to other sophisticated investors, primarily hedge funds and commodity pools. BTX531.3, 75.9, 324, 325. By 2006, the latter entities made up 35% of Sentinel's customer base, with FCMs constituting the balance. *Id.*

Sentinel pooled its managed assets into portfolios. The main portfolios were the 125 Portfolio for investing in assets appropriate for FCM customer funds under Commodity Futures Trading Commission ("CFTC") regulations, 17 C.F.R. §1.25, and the Prime Portfolio for hedge funds, proprietary (or "house") FCM funds, and other non-regulated funds. BTX216, 246.16-17; Tr.234-35, 238-39. By definition, the Prime Portfolio was not subject to CFTC rules regarding FCM customer funds. *Id.* Sentinel claimed its portfolio pooling enhanced its bargaining power and ability to diversify. BTX74.2, 75.8, 207.5, 209, 216. Sentinel's aggregations of capital also enabled it to maintain liquidity by trading short-term bonds while buying longer-term bonds and holding them to maturity to increase portfolio yields. BTX34.1, 207.5, 209, 216.

Sentinel had several ways to ensure it could satisfy redemption requests, including generating cash by selling securities and employing leverage. BTX75.3-.5. Sentinel entered into a relationship with BNYM that allowed it to borrow cash by pledging long-term securities as collateral. BTX34.1-.2; Tr.2282-83. Sentinel also engaged in repurchase transactions with such counterparties as Cantor Fitzgerald and FIMAT—essentially another form of secured credit—enabling it to "sell" securities overnight to obtain needed liquidity. Sentinel frequently rolled over these repurchase transactions from day-to-day. A.36(SOF¶¶98-100).

Sentinel's use of leverage was no secret to its customers, outside auditors, or regulators, who were informed both in writing[1] and orally.[2] The SEC and Sentinel's customers annually received Sentinel's Investment Advisor Form ADV, which described Sentinel's leveraged trading activities. A.28(SOF¶37; A.35-36(SOF¶¶90-91). Sentinel also provided its regulators and requesting customers with copies of its audited financial statements, which disclosed its loan with BNYM and its repurchase borrowings. A.35(SOF¶88); BTX183, 218, 231. Sentinel's largest investor, Capital Fund Management, was told in 2006 by a Sentinel competitor with whom it was considering investing that Sentinel's portfolio likely "contains a heavy dose of structured securities or leverage in order to achieve such above market returns." BTX205; Tr.1534-36.

Sentinel was predominately an investment manager. It never solicited or accepted orders for the purchase or sale of any commodity for future delivery (A.24(SOF¶8)), which should have precluded its registration as an FCM. See 7 U.S.C. §1a(20); 17 C.F.R. §1.3(p). But the CFTC allowed Sentinel to register as an FCM in 1980 (BTX1.2), and in 1981 granted Sentinel no-action relief from the minimum net-capital requirements that apply to actual FCMs. A.24(SOF¶6). In 2004, the CFTC conducted an in-depth review of Sentinel and reaffirmed its no-action position. A.26(SOF¶25).

Sentinel was subject to oversight by three separate regulatory agencies, the SEC, CFTC, and National Futures Association ("NFA"), as well as to periodic

[1] BTX35, 75, 109, 121, 144, 176, 205, 207, 209, 216, 218, 231, 411, 539-40, 756.1, 757, 791; TTX118, 120, 165, 225.

[2] Tr.2320–22, 2328–30; BTX75.4, 176, 207.

audits by the SEC and NFA, as well as by McGladrey & Pullen, Sentinel's outside auditor, which filed annual reports with the SEC on Sentinel's compliance with the Investment Advisers Act of 1940. A.28(SOF¶38). Sentinel also filed daily and monthly financial statements with the NFA. A.24(SOF¶4); A.26-27(SOF¶¶20-38). The NFA was well informed of Sentinel's business model, as reflected in a diagram and memorandum it prepared detailing Sentinel's account structure at BNYM and related secured loans. A.27(SOF¶32); BTX531.

B. Sentinel's Accounts and Secured Loan

Sentinel's relationship with BNYM began in 1997. Tr.590; TTX18.1. Sentinel was originally assigned to BNYM's institutional custody division (Tr.590-91; TTX5.2), but it soon was transferred to BNYM's clearing division, Broker Dealer Services ("BDS"), because Sentinel actively traded securities and routinely financed transaction settlements. TTX18.1; Tr.2007-22. In October 1997, Sentinel and BNYM executed the necessary agreements, and BNYM then set up Sentinel's BDS accounts. TTX21; BTX14.

Sentinel's BDS accounts were divided into three groups. First, clearing accounts, which were lienable by BNYM, allowed Sentinel to buy or sell securities. Tr.392-93, 2023-24; BTX14.4; TTX21.5 §3.04. Each clearing account allowed Sentinel to trade a specific type of security: the "SEN" account cleared and settled book-entry government securities (such as U.S. treasury bonds); the "DTC" account cleared and settled Depository Trust Company securities (such as U.S. corporate bonds); the "Euroclear" account cleared and

settled foreign securities; and the "physical securities" account held securities traded with physical certificates. BTX531.7; Tr.210-14, 488-90.

Second, Sentinel had a loan account used in conjunction with its secured line of credit. TTX21.5, §§3.01, 3.02. To book a loan, Sentinel would call Bank administrators to confirm sufficient collateral in its lienable accounts. Tr.980-81. If the loan was above the predetermined "guidance line," it could be booked only with senior executive approval. Tr.579-81.

Finally, "segregated" or "seg" accounts held assets not subject to any BNYM lien. TTX21.3, §2.04(a). These included three accounts to hold fully-paid government securities and three accounts to hold fully-paid DTC securities. Sentinel set up this structure to segregate its clients' assets and its own assets from assets held in lienable accounts to secure BNYM's loans. BTX531; TTX188.2.

Additionally, from 2004 onward Sentinel maintained segregated cash accounts at BNYM competitor JPMorgan Chase. A.37(SOF¶¶102-07); BTX817A. Average monthly balances in those accounts ranged as high as several hundred million dollars. *Id.* BNYM did not receive statements for these accounts. Tr.291-92.

Sentinel's account structure at BNYM kept segregated accounts completely free of BNYM's lien. BNYM formally acknowledged that "Bank will not have, and will not assert, any claim or lien against Securities held in a Segregated Account nor will Bank grant any third party, including any Federal Reserve Bank, any interest in such Securities." TTX21.3, §2.04(a). To shield

any of its assets—including those managed on behalf of its customers—from BNYM's lien, Sentinel simply had to transfer and keep them in a segregated account.

As with all of BNYM's clearing clients, Sentinel could independently transfer assets among its accounts and perform trades with minimal Bank involvement or knowledge. Tr.901, 1050, 2010-12. To move assets from a segregated account to a clearing account, Sentinel had only to issue an electronic "Desegregation Instruction." TTX21.3, §2.04(b). To move assets from a clearing account to a segregated account, Sentinel would issue a similar "Segregation Instruction." TTX21.3, §2.04(a). The computerized system for moving government securities was completely automated; no BNYM employee saw the securities movements. Moving DTC corporate securities was only slightly less automated; back office Bank employees would ensure that customers like Sentinel correctly entered transfer orders and then authorize their execution. Tr.901-02, 941-44.

This highly-automated account structure was necessary given the enormous volume of settlement activity for which clearing banks are responsible. At BNYM, such daily settlement activity consisted of "about 150,000 transactions, on average," which could "spike up to 600,000 or so," with a daily dollar value averaging "3 to 4" trillion dollars. Tr. 562. According to Allen Clark, former head of JPMorgan Chase's clearing department, settlement activity at JPMorgan, BNYM's sole competitor for clearing services, similarly "average[d] 150,000 transactions on a daily basis", with a dollar value of

transactions in excess of $2 trillion dollars. *Id.* at 1999-2000. In this context, it was not unusual for BDS clients to transfer hundreds of millions of dollars of securities from segregated accounts to lienable accounts on a daily basis. Tr. 946.

The account structure was also designed to meet Sentinel's own significant daily transfer and trading activity. Grede's accounting expert, James Feltman, testified that Sentinel's activity in its clearing account on July 27, 2007 consisted of 15 trades in excess of $300 million, wire transfer deposits from at least ten Seg 1 and Seg 3 customers in excess of $91 million, and disbursements of $48 million to five Seg 1 and six Seg 3 customers. Tr.1932-33, 1936-38; TTX 1068. Sentinel's trading activity was consistent with typical BDS activity, according to Clark, which "ran the gamut" from "20 transactions" to "multiples of thousands of transactions on a daily basis." Tr. 2000; Tr. 2010-18.

BYNM "would not have seen the movement of collateral to and from seg accounts" in its collateral reports, and BNYM did not receive Sentinel's segregation reports or internal reports allocating the ownership of individual securities among Sentinel's portfolios. A.65; A.34(SOF¶¶72-74); Tr.277-87. It was Sentinel's responsibility to keep assets segregated if they were not to be pledged. As Sentinel represented and warranted in the Clearing Agreement, it

> own[ed] the Securities in the [clearing] Account free and clear of all liens, claims, security interests and encumbrances (except those granted herein) or, if the Securities in the Account are owned beneficially by others, [Sentinel] has the right to pledge such Securities to the extent financed by Bank hereunder,

> free of any right of redemption or prior claim by the beneficial owner.

TTX21.6 §4.01(d). The Clearing Agreement also provided that Sentinel's "delivery of a Desegregation Instruction shall constitute a representation and warranty by [Sentinel] to and for the benefit of Bank that [Sentinel] is authorized to issue such Desegregation Instruction and by so doing to transfer and pledge to Bank the full value of any and all such Securities." *Id.* §2.04(b). Sentinel further represented and warranted that it was "conducting its business in compliance with all applicable laws and regulations, both state and federal, and has obtained all regulatory licenses, approvals and consents necessary to carry on its business as currently conducted." TTX21.6 §4.01(c); see also *id.* §4.02(d).

Standard clearing agreements used by JPMorgan Chase similarly allocate rights and responsibilities. Tr.2020-23. According to Clark, reliance on representations and warranties is "essential" in the clearing industry because "[i]t's not possible to know all of the transactions that have taken place with [the bank's] client or *** downstream clients," and the bank "can't possibly know every rule or regulation that any potential client might be subject to." *Id.* at 2021-22.

At the end of each day, BNYM would ensure that Sentinel had sufficient collateral in lienable accounts to book an overnight loan. The loan was unwound the next morning, with Sentinel again able to move securities into and out of lienable accounts. See Tr.978-84. These processes ensured that

BNYM's loan to Sentinel was never undersecured. Otherwise all movements between accounts were entirely Sentinel's responsibility.

C. Sentinel and BNYM: 1997-May 2007

For a decade, Sentinel was a relatively unremarkable client. Most of the Bank officers who managed the Sentinel relationship in summer 2007 had been doing so for years. Tr.821-22 (Fraser), 1061 (Brennan), 1248 (Law), 2636 (Rogers). Although Sentinel was a problem-free borrower during that time, these officers made sure they understood Sentinel's business and the credit risk associated with its loan. BNYM officers visited Sentinel's offices (TTX170; Tr.633, 1225-26), and credit personnel prepared summaries of Sentinel's financial statements. TTX115, 171-72, 179, 185. Bank officers also called Sentinel's chief financial officer to discuss Sentinel's regulatory filings and audited financial statements, held internal meetings to discuss the loan and internal guidance line, and had an information-gathering phone call in April 2006 with Sentinel's Eric Bloom. Tr.1154-56, 1228, 1393-94; TTX183; BTX324-25. The Bank officers learned nothing that raised any suspicion that Sentinel was misusing customer assets for its own benefit. Tr.637-39, 1225-26, 2634-35, 2669-71.

BNYM took comfort from knowing that Sentinel had ongoing relationships with sophisticated repo counterparties, such as Cantor Fitzgerald and FIMAT, who conducted significant diligence before extending up to $2 billion of secured credit to Sentinel and similarly expressed no concern about Sentinel or its trading activity. Tr.603-04. A wide variety of sophisticated

individuals also found Eric Bloom knowledgeable and trustworthy. *E.g.*, Tr.775, 1538, 2330-33. BNYM took additional comfort from the fact that Sentinel's auditors and regulators regularly reviewed Sentinel's operations. A.26-28(SOF¶¶20-21, 28, 34, 37-38); Tr.602, 2644-45. BNYM responded regularly to auditors' and regulators' requests for information regarding Sentinel's loan amount, lienable and non-lienable account balances, and other information. *E.g.*, A.27-28(SOF¶¶29-31, 35-36); BTX60, 63, 105-07, 162-63, 193, 213-15, 219. BNYM also sent its clearing agreements with Sentinel to the CFTC and NFA. A.26-27(SOF¶¶26, 33). No regulator, auditor, customer, or other third-party ever voiced any concern to BNYM about Sentinel. *E.g.*, Tr.406, 761-63, 1509-10, 1516-18.

D. Summer 2007 Transfers

A severe financial crisis hit the markets in summer 2007. See Markus Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, 23 J. Econ. Perspectives 77, 77 (2009) (noting "the plethora of market declines, liquidity dry-ups, defaults, and bailouts that occurred after the crisis broke in summer 2007"). As the markets convulsed, repurchase lenders "began to get skittish" due to rising credit concerns. Tr.2852-53. As expert financial economist Bradford Cornell explained, "unfortunately for Sentinel," the market's concerns were "focused on the types of securities *** that [Sentinel] happened to hold." *Id.* Sentinel's counterparties in several large repurchase transactions refused to accept securities previously used as collateral and required Sentinel to unwind its borrowings. Tr.473-74. The same credit fears

that led the counterparties to pull their repurchase agreements also prevented Sentinel from selling the underlying securities as "it was very difficult to get people to pay cash on the barrel head." Tr.2584-85, 2857. Sentinel made the demanded payments, with a corresponding increase in the BNYM loan balance and underlying collateral. Tr.473-74; *E.g.*, TTX248, 266-69, 285, 288, 307-09.

On June 1 and again on June 26, 2007. FIMAT, a repo counterparty, required Sentinel to repurchase physical securities. A.38-39(SOF¶¶109, 116); Tr.1834. Due to this and other settlement activity on those trading days, Sentinel's overnight loan balance increased. A.38-39(SOF¶¶112, 118). To secure this increase, Sentinel transferred government and other securities from its Seg 1 and Seg 3 accounts to its clearing accounts. *Id.* ¶¶110, 117. Sentinel also used the returned physical securities as collateral for the increase in its overnight loan. Tr.994-95, 1841.

On June 27, 2007, Sentinel's loan balance increased to $573 million. A.39(SOF¶122). The size of the loan required and received approval from Rogers. Tr.2700. After a series of meetings and in response to the same market uncertainty that caused FIMAT to close out the repos, on June 29 BNYM informed Sentinel that it would not accept physical securities as collateral. TTX374. Sentinel then transferred $166 million in securities from its Seg 1 account into its lienable DTC clearing account. A.40(SOF¶131). As the market turmoil continued, similar transactions occurred on July 17. A.42(SOF¶¶142-44). As noted *supra* pp. 7-11, BNYM verified the amount and nature of collateral in the lienable accounts at the end of each day, not the source of any

collateral transferred into those accounts. There was nothing unusual about movements of securities of this magnitude by clearing customers. Tr. 946.

A very different (in fact, reverse) type of transaction occurred on July 30. Sentinel transferred $248 million of DTC securities from its DTC clearing account into its DTC Seg 1 account. A.42(SOF¶149). This transfer reduced the amount of securities subject to BNYM's lien. The next day, Sentinel transferred an additional $263 million of securities from its government securities clearing account to the Seg 1 accounts. A.43(SOF¶150). It also moved $289 million of DTC securities from its Seg 3 account into its DTC clearing account. *Id*. The net effect of these three transactions was a reduction in the amount of BNYM's collateral by hundreds of millions of dollars.

E. Sentinel Collapses

Sentinel ultimately could not cope with its investment losses. It told clients and BNYM that it was halting customer redemptions as of August 13. A.44(SOF¶¶159-60). BNYM formed a team to manage the Sentinel situation (Tr.1233), limited Sentinel's remote access to BNYM's systems (A.44(SOF¶162)), and sent Bank employees to Sentinel's offices (Tr.1415). On August 16, BNYM demanded that Sentinel repay its loan in full (BTX579), followed by a letter informing Sentinel that BNYM otherwise would liquidate the loan collateral by August 22. BTX580. On August 17, Sentinel filed for bankruptcy. A.45(SOF¶174). On that date, Sentinel's outstanding indebtedness to BNYM was $312,247,000. TTX614.22.

The SEC and CFTC subsequently filed securities fraud claims against Sentinel and its principals, alleging risky trading for the benefit of Sentinel's insider-owned house portfolio and improper use of customer assets from segregated accounts as collateral without regard to whether that left the accounts under-segregated. *SEC v. Sentinel Mgmt. Group*, No. 07-4684 (N.D. Ill. filed Aug. 20, 2007); *CFTC v. Sentinel Mgmt. Group*, No. 08-2410 (N.D. Ill. filed Apr. 28, 2008). Both lawsuits are pending.

F. District Court Proceedings

Pre-trial proceedings. Grede was appointed Chapter 11 Trustee for the Sentinel estate (A.46(SOF¶¶175–76)) and subsequently Liquidation Trustee of the Sentinel Liquidation Trust. A.23(SOF¶1); TTX867. BNYM, the only secured creditor as of August 17, 2007, asserted a claim against the estate for over $312 million.

In March 2008, Grede filed an adversary proceeding against BNYM. Focusing on Sentinel's summer 2007 account transfers, he alleged that Sentinel engaged in repurchase transactions for the benefit of its insiders and used customer assets to secure financing from BNYM. R.88 ¶¶79-128. Grede further alleged that BNYM knew of Sentinel's misconduct. *Id.* ¶¶129-45. Grede claimed, *inter alia*, fraudulent transfers under the Bankruptcy Code and state law; preferential transfers under Code §547(b); equitable subordination of BNYM's secured claim under Code §510(c); and invalidation of BNYM's lien under Code §506(d). *Id.* ¶¶186-219, 239-47.

Judge Zagel dismissed several counts on the pleadings. As relevant here, he dismissed the lien invalidation count, holding that Grede's allegations about BNYM's flawed processes did not make the underlying clearing agreements illegal. A.17-18. Grede amended his complaint to reflect that ruling (R.88), and BNYM subsequently moved for summary judgment on Grede's fraudulent transfer, preference, and equitable subordination counts. R.246. The court reserved decision on BNYM's motion at Grede's request, and a bench trial commenced in April 2010.

The Trial and District Court Ruling. Judge Zagel presided over fifteen days of trial, reviewed voluminous exhibits, and heard testimony filling thousands of transcribed pages. The witnesses included Mr. Grede (Tr.181-315, 1703-17); Bank employees Joseph Ciacciarelli (Tr.470-702), Evan Fraser (Tr.821-94), Ronald Silk (Tr.895-968), Stephen Johnson (Tr.975-1054), Stephen Brennan (Tr.1172-1248), Terence Law (Tr.1248-1453), and Mark Rogers (TR.2617-2808); Sentinel sales manager Steven Stitle (Tr.2307-41); CEOs or CFOs from Sentinel customers Kottke Associates (Tr.710-78), TransAct Futures (Tr.779-817), and Capital Fund Management (Tr.1454-1541); Sentinel's outside auditor Michael Liccar (Tr.2247-2307); Grede's experts Charles Hohman (Tr.1543-1700) and James Feltman (Tr.1717-1961); and BNYM's experts Allen Clark (Tr.1990-2188), Wallace Bankhead (Tr.2385-2616), and Bradford Cornell (Tr.2808-2904).

The court ruled in favor of BNYM on all counts. On the fraudulent transfer claims, the court found that, "[b]ased on the evidence presented at

trial," Grede "failed to prove that Sentinel made the Transfers with the actual intent to hinder, delay or defraud creditors." A.48. Judge Zagel explained that Grede "presented little direct evidence of Sentinel's intent at trial" (*id.*) and "failed to demonstrate that the requisite intent may be inferred through the existence of the badges of fraud." A.48, 50.

The court rejected Grede's proposed presumption of actual intent to defraud creditors, finding that Grede "failed to prove that Sentinel knew at the time of the transfers" that its insiders' "scheme would collapse." A.49-50. Instead, based on the trial record, Judge Zagel found it "reasonable to infer that the Transfers were made to secure the loan in an attempt to continue conducting business and paying off existing creditors." A.52. In particular, the transfers to BNYM did not "result in the draining of [Sentinel's] asset pool" because, "in exchange for the collateral, BNYM gave a loan of significant value, thereby adding to the pool." *Id.* At most, the evidence showed that "Sentinel schemed to pay certain creditors—the repo counterparties—and to keep its line of credit open presumably in an attempt to stay in business, not to drain its assets and make them unavailable to other creditors." A.53.

In its only summary judgment ruling, the court rejected Grede's preferential transfer claim, relying on evidence that BNYM was "overcollateralized" on the dates of the relevant transfers. A.54-55. Grede has not challenged the district court's preferential transfer ruling on appeal.

Finally, the court rejected Grede's equitable subordination claim. Judge Zagel found that BNYM's conduct was not "egregious or conscience shocking"

but at most could be deemed "negligence," which "does not satisfy the requirements of equitable subordination." A.82.

Judge Zagel also found that Grede failed to prove that BNYM "knew of or was deliberately indifferent to Sentinel's misconduct." A.64. BNYM "had a relatively unremarkable ten-year relationship with Sentinel" and "had assurances from Sentinel that it was authorized to use customer securities for collateral," and Sentinel's customers "were aware" of its "leveraged trading strategy." A.64-65. And even if BNYM "should have been more diligent with regard to verifying the source of collateral, such a lack of care does not rise to the level of the egregious misconduct necessary for equitable subordination." *Id.* Further, the evidence showed that BNYM and its employees lacked motivation to "turn a blind eye to Sentinel's misconduct," and their actual "course of conduct" contradicted Grede's allegations that they did. A.65-66.

The court supported these findings with credibility determinations based on extensive witness testimony. Although Judge Zagel "did not believe" certain testimony from Bank employees, he concluded that those witnesses were simply worried about the "professional consequences" of their failure to scrutinize Sentinel's loan more carefully and were not covering up wrongdoing. A.68-69. And merely because "they would have been better bankers if they had made a more rigorous inspection of Sentinel's operations or its reporting is not enough" for the extraordinary remedy of equitable subordination. A.70. The court rejected Grede's attempt to substitute a "reasonable person" objective standard, explaining that Grede's cited cases do not support such a negligence

standard, which would "not fit well with the concepts of inequity and misconduct." A.70-72.

Judge Zagel then made detailed findings that BNYM did not violate any duties or otherwise engage in conscience-shocking conduct. A.74-82. He found that BNYM "complied with the segregation requirements" under the Commodity Exchange Act ("CEA") and segregation letters and "never liened on any securities in the segregated accounts." A.74; see also A.56-59. Further, BNYM "was largely unaware of Sentinel's investment decisions, what Sentinel did with the loan, or how securities were allocated among clients and the house account." A.74. Nor did BNYM have any reason to question Sentinel's assurances that its asset transfers were appropriate; it "knew that Sentinel was regularly audited by outside firms and regulated by the NFA—facts from which BNYM employees did take comfort." A.76. BNYM also had "no obligation to monitor Sentinel's transactions," which "would have been nearly impossible given the speed and number of transactions." *Id.* Finally, the court found that BNYM did not violate any other statutory duties, "industry practice," or common law, as Grede contended. A.80-82.

SUMMARY OF THE ARGUMENT

Grede's appeal rests on a misunderstanding of the standard of review. After hearing fifteen days of testimony from numerous fact and expert witnesses, reviewing thousands of pages of exhibits, and listening to hours of recorded phone calls between BNYM and Sentinel employees, Judge Zagel found that Grede failed to prove the required elements of his fraudulent

transfer and equitable subordination claims. Grede disagrees with the court's factual findings and credibility determinations and seeks to convince this Court that *his* view of the facts and witnesses is *better* than Judge Zagel's. He therefore argues as if engaged in a second trial. But on appeal he must show that the district court's findings are *clearly* erroneous, a standard that requires Judge Zagel's findings to strike this Court "as wrong with the force of a five-week-old, unrefrigerated dead fish." *Parts & Elec. Motors, Inc. v. Sterling Elec., Inc.*, 866 F.2d 228, 233 (7th Cir. 1988). Grede does not come close to satisfying that demanding standard.

Grede also asks this Court to promulgate sweeping new liability rules that would cast aside established limits on fraudulent transfer and equitable subordination claims. His demands not only are inconsistent with governing precedent but also would impose enormous and unwarranted costs on the financial services industry and its customers.

I.

The court's ruling that Grede failed to prove the actual intent element of his fraudulent transfer claim was well supported. Grede offered no direct evidence that Sentinel made the challenged account transfers with the specific intent to defraud its creditors. The evidence showed that Sentinel made the transfers to satisfy demands, prompted by a severe market crisis, from repurchase counterparties. Grede also failed to prove intent by circumstantial evidence. The district court found that that the "badges of fraud" weigh heavily against a finding of intent. Grede now asks this Court to discard the centuries-

old badges of fraud test, but he offers no alternative circumstantial evidence to establish intent. Instead, Grede seeks a "presumption" of intent that has no statutory or case-law support, thereby underscoring his lack of evidence.

II.

Judge Zagel's rejection of Grede's equitable subordination claim also was well supported. Equitable subordination of non-insider claims is rare, justifiable only by egregious misconduct that the court found did not occur here.

In particular, the court found that BNYM did not know of or willfully disregard any misconduct by Sentinel. That finding was based on evidence showing that BNYM had a longstanding and trouble-free relationship with Sentinel, whose business model worked well until the market collapse of 2007; BNYM's loan and Sentinel's leveraged investment strategy were disclosed to—and accepted by—regulators, independent auditors, repo counterparty institutions, and Sentinel's sophisticated customers; the Sentinel account structure was disclosed to regulators; Sentinel directed all transfers between its accounts at BNYM with representations and warranties that it owned or had the legal right to pledge all transferred assets; BNYM did not breach any duties under the CEA (to the extent it had any) because it never asserted a lien on any assets in segregated accounts; BNYM's concerns about Sentinel in summer 2007 were directed to credit risk—the size of Sentinel's loan balance and the quality of the collateral—not to the lawfulness of Sentinel's conduct; and no one at BNYM learned of Sentinel's alleged misconduct until after its

bankruptcy. Moreover, far from obtaining an "unfair advantage" from the transfers, as Grede charges, BNYM made arm's-length loans to Sentinel secured by pledges of collateral.

Grede's attempt to impose a duty on depository banks to monitor the underlying beneficial ownership of customer-pledged collateral has no support in the law and would be impracticable and unduly costly and burdensome.

III.

The district court properly dismissed Grede's claim that contracts underlying Sentinel's accounts at BNYM were illegal. Grede erroneously conflates his allegations of illegal performance with illegality of the contracts themselves.

ARGUMENT

Grede seeks to cast aside the established standard of review, asserting (at 30, 41) that review of the findings below is "de novo" and challenging the district court's detailed evidentiary and credibility determinations. But in reviewing bench-trial findings, "appellate courts must constantly have in mind that their function is not to decide factual issues de novo." *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 123 (1969). Rather, such findings are entitled to "great deference," to the point that a trial court's choice between "two permissible views of the evidence *** ***cannot*** be clearly erroneous" and "***a trial court's credibility determination can virtually never amount to clear error***." *Gaffney v. Riverboat Servs., Inc.*, 451 F.3d 424, 447-48 (7th Cir. 2006) (emphasis added); accord *Carnes Co. v. Stone Creek Mech., Inc.*, 412 F.3d

845, 848 (7th Cir. 2005). This is "an exceptionally heavy burden to carry on appeal," especially "when the appellant argues that the district court erred in crediting or discrediting a witness's testimony." *Chicago Prime Packers, Inc. v. Northam Food Trading Co.*, 408 F.3d 894, 899 (7th Cir. 2005). As demonstrated below, Grede cannot sustain that burden.

I. The District Court Properly Rejected Grede's Fraudulent Transfer Claim Because He Did Not Prove That Sentinel Actually Intended To Defraud Its Creditors.

Grede contends that several transfers by Sentinel from segregated to lienable accounts in June and July 2007 were made "with actual intent to hinder, delay, or defraud" Sentinel creditors. Grede Br. 29, citing 11 U.S.C. §548(a)(1)(A). Grede does not contend the transfers were constructively fraudulent under 11 U.S.C. §548(a)(1)(B), presumably because Sentinel plainly did not receive "less than a reasonably equivalent value in exchange for such transfer(s)." *Id.* §548(a)(1)(B)(i). And on appeal Grede has not pursued his state-law fraudulent transfer claim under 740 ILCS 160/5(a)(1)—his brief does not mention it. As demonstrated below, the district court properly found that Grede failed to prove the elements of his actual fraudulent transfer claim under §548(a)(1)(A).

As an initial matter, the transfers at issue cannot have been fraudulent within the meaning of the Code because they did not deplete the estate. A.52. BNYM was fully secured at all times (A.44(SOF¶158); Tr.1203), and "payment to a fully secured creditor does not hinder, delay or defraud creditors because it does not put assets otherwise available in a bankruptcy distribution out of

their reach.” *In re First Alliance Mortgage Co.*, 471 F.3d 977, 1008 (9th Cir. 2006); accord *Melamed v. Lake County Nat’l Bank*, 727 F.2d 1399, 1402 (6th Cir. 1984). This neutral impact provides an independent ground for affirmance.

A. The district court’s finding that Grede failed to prove actual fraudulent intent was not clearly erroneous.

The district court found, “[b]ased on the evidence presented at trial,” that Grede “failed to prove that Sentinel made the Transfers with the actual intent to hinder, delay or defraud its creditors.” A.48. Judge Zagel noted that Grede “presented little direct evidence of Sentinel’s intent.” *Id.* That was an understatement. Grede’s burden was to prove that Sentinel made the transfers with the specific intent to prevent its creditors from reaching its assets. See *King v. Ionization Int’l, Inc.*, 825 F.2d 1180, 1186 (7th Cir. 1987) (actual fraudulent intent means that “the main or only purpose of the transfer was to prevent a lawful creditor from collecting a debt”); *In re Jeffrey Bigelow Design Group*, 956 F.2d 479, 484 (4th Cir. 1992) (“actual fraudulent intent requires a subjective evaluation of the debtor’s motive”). Yet, Grede offered no testimony from any Sentinel employee regarding Sentinel’s intent when making the transfers or any other evidence of specific intent. Indeed, he offered no testimony from Sentinel employees at all (in contrast to BNYM, which presented the testimony of former Sentinel sales manager Steven Stitle).

Instead, Grede contends (at 30-32) that the transfers from segregated to lienable accounts were fraudulent transfers because they were made while Sentinel insiders were perpetrating a fraudulent scheme. Grede would thereby effectively discard the requirement of actual intent to harm creditors by the

subject transfers. See *In re Sharp Int'l Corp.*, 403 F.3d 43, 56 (2d Cir. 2005) (rejecting fraudulent transfer claim where debtor's fraud was separate from challenged transfers); *First Alliance*, 471 F.3d at 1009 (rejecting fraudulent transfer claim where transfers were not intended to defraud creditors notwithstanding debtor's independent misrepresentations). As this Court has explained, "[s]omeone who sells a car at the market price to Charles Ponzi is entitled to keep the money without becoming liable to Ponzi's victims for the loss created by his scheme." *B.E.L.T., Inc. v. Wachovia Corp.*, 403 F.3d 474, 477 (7th Cir. 2005) (rejecting fraudulent transfer claim). Like the plaintiff in *B.E.L.T.*, Grede failed to prove Sentinel's actual fraudulent intent to harm creditors in making the challenged transfers to secure its loans.

Grede takes issue with the district court's evidentiary findings and the inferences it drew from them. Whereas Judge Zagel found that "the evidence at trial" proved that Sentinel sought to "close out repo positions and refinance or sell the returned securities" and "to keep its line of credit open presumably in an attempt to stay in business, not to drain its assets and make them unavailable to other creditors" (A.49, A.53), Grede draws different inferences from those facts. But this is an appeal, not a retrial of this massive case, and the mere fact that Grede can hypothesize a nefarious intent on the part of Sentinel does not mean that the court clearly erred in finding otherwise. See *In re Krehl*, 86 F.3d 737, 743 (7th Cir. 1996) (question of whether debtor "acted with the actual and specific intent to defraud [is] one of fact that we review only for clear error").

Moreover, Grede offers no evidence of the ordinary hallmarks of fraud—*concealment* and *misrepresentation*—other than customer account statements that BNYM never saw. He focuses on a leveraged investment model, account structure, and bank loan that Sentinel disclosed to customers, auditors, regulators, and lenders. They all had access to Sentinel's audited financial statements, for example, which disclosed that Sentinel had $2 billion in repurchase transactions and for years had a sizable bank loan for which it pledged securities worth hundreds of millions of dollars as collateral. A.48-49; see TTX85, 118, 120, 165, 225. BNYM also provided account balance confirmations to auditors and regulators, disclosing *inter alia* the amount of Sentinel's loan and the securities in lienable and segregated accounts. *E.g.*, BTX60, 63, 105-07, 162-63, 193, 213-15, 219. The NFA was sufficiently informed to prepare a detailed memo describing Sentinel's account and loan structure. A.27(SOF¶32). And Sentinel's customers signed investment management agreements and received explanatory welcome letters, Forms ADV, audited financial statements, and account statements that disclosed Sentinel's leveraged investment strategy. A.35-36(SOF¶¶88-92); Tr.2825-30. Sentinel's relationship with BNYM was thus transparent to regulators and stakeholders. See *B.E.L.T.*, 403 F.3d at 478 (debtor's principal concealed a fraud "but the *debt* ***, and the *transfers* in payment of that debt, were disclosed and transparent").

Grede also suggests (at 31-32) that Sentinel's supposed violations of federal segregation requirements are direct evidence of fraudulent intent. But

any such violations have not been established, and fraud is not a strict liability offense—Grede still must prove that Sentinel *intended* to defraud creditors *by means of* the specific transfers at issue. See *In re Kennedy*, 279 B.R. 455, 462 (Bankr. D. Conn. 2002) (debtor's intent in misappropriating funds from trust accounts "neither proves nor implies anything with respect to his intent vis-à-vis his creditors *in transferring* those funds to [d]efendant").

None of the potpourri of cases cited by Grede (at 30-32) supports his actual fraudulent intent argument. Simply because courts found such intent in very different factual scenarios says nothing about whether Judge Zagel clearly erred in not finding it here. *E.g.*, *In re Randy*, 189 B.R. 425, 439, 442-43 (Bankr. N.D. Ill. 1995) (broker commissions paid by convicted Ponzi scheme operator were intended to obtain new victims); *In re Bell & Beckwith*, 64 B.R. 620, 629 (Bankr. N.D. Ohio 1986) (defendants "admitted" their managing partner "intended to defraud the creditors of the Debtor at the time he diverted the funds from their accounts"); *In re Cannon*, 230 B.R. 546, 588-91 (Bankr. W.D. Tenn. 1999) (attorney admitted his escrow account embezzlements were intended to defraud clients)[3]; *SEC v. Brown*, 643 F. Supp. 2d 1077, 1080-82 (D. Minn. 2009) (*allegation* of intent to defraud sufficient to survive motion to dismiss). Grede (at 34-35) also cites cases holding that a "genuine belief" that a fraudulent scheme was for the best cannot overcome proof of an actual intent

[3] Grede should have noted that *Cannon*, which he cites four times (at 31, 35, 36, 37), was reversed on appeal for the trustee's lack of standing. *In re Cannon*, 2000 WL 34400479 (W.D. Tenn. Mar. 31, 2000).

to defraud creditors. But those cases say nothing about a case, like this one, where actual intent was never proven at all.

Grede (at 33) also cites *Dean v. Davis*, 242 U.S. 438 (1917), for the proposition that a transfer favoring one creditor over another is a "fraudulent preference." But Grede has not appealed from the district court's rejection of his preferential transfer claim, and the Court in *Davis* properly distinguished a "fraudulent transfer" from "a preference" (*id.* at 444), a distinction that is well established. As then-Judge Breyer explained, "fraudulent conveyance law does *not* seek to void transfers *** known as a 'preference'. *** The basic object of fraudulent conveyance law is to see that the debtor uses his limited assets to satisfy *some* of his creditors; it normally does not try to choose among them." *Boston Trading Group v. Burnazos*, 835 F.2d 1504, 1508-09 (1st Cir. 1987); accord *B.E.L.T.*, 403 F.3d at 478 (distinguishing fraudulent from preferential transfers).

In sum, the district court's ruling that Grede failed to prove actual fraudulent intent was not clearly erroneous.

B. The district court properly rejected Grede's plea for a "presumption" of fraudulent intent.

Lacking direct evidence, Grede argues (at 35-38) for a presumption of actual fraudulent intent, which the district court properly rejected. Noting that Grede relied on cases involving Ponzi schemes where the perpetrator knows in advance that the scheme will collapse, the court explained that Grede "failed to prove that Sentinel knew at the time of the transfers that [its] scheme would collapse." A.49-50. Rather, "the evidence at trial proved" that Sentinel made the

transfers in an attempt to keep its "line of credit open" and weather the financial crisis ravaging its business. A.49.

Generally, "[t]he existence of actual intent to defraud is never presumed." *Lippe v. Bairnco Corp.*, 249 F. Supp. 2d 357, 375 (S.D.N.Y. 2003), aff'd, 99 F. App'x 274 (2d Cir. 2004); see *Boston Trading Group*, 835 F.2d at 1512 ("If, with all motives fully known, we would not find actual intent to defraud, what reason could there be for *presuming* fraudulent intent?"). The only exception is for transfers in furtherance of a Ponzi scheme, which "have achieved a special status in fraudulent transfer law." *In re Cohen*, 199 B.R. 709, 717 (B.A.P. 9th Cir. 1996). Here, the district court rightly refused to extend that presumption. Presuming fraudulent intent based on *any* "overall scheme," as Grede urges (at 36), would effectively reverse the established burden of proof. It also would transform the fraudulent transfer doctrine from a narrow creditor remedy focused on estate-diminishing transfers into a cure-all for all creditor injuries from generalized debtor misconduct.

Grede offers no support for such an extension of the Ponzi scheme presumption or expansion of fraudulent transfer law. The cases he cites (at 35-36) involved either *actual* Ponzi schemes or functionally equivalent schemes that used later deposits to pay off earlier ones. The court in *In re Bayou Group*, 439 B.R. 284, 306-07 (S.D.N.Y. 2010), found "all of the essential elements" of a Ponzi scheme. In *Cannon*, 230 B.R. at 590, the embezzling attorney used later deposits to cover up his escrow thefts knowing "that if he could not sustain the concealment *** the last group of clients would be left with nothing." And in *In*

re Model Imperial, 250 B.R. 776, 792 (Bankr. S.D. Fla. 2000), the so-called "presumption of fraudulent intent" came only after findings of "direct evidence" and five badges of fraud.

Sentinel's leveraged investment model was not a Ponzi scheme. Sentinel paid out returns on actual investments (A.49), rather than inflate returns by using principal payments from later investors. Its investment strategy worked for years, and even Grede's experts admitted that Sentinel's use of leverage long provided investors with significant additional returns. *E.g.*, Tr.1896-1901, 1909, 1634-35. It may be obvious in hindsight—after "the biggest period of financial turmoil since the Great Depression" (Tr.2852; accord Brunnermeier, *supra* p. 12, at 77)—that such leveraged returns were accompanied by risk of greater losses. But the same is true of many investment strategies that likewise are far from Ponzi schemes. Moreover, as the district court found, Sentinel's customers, unlike Ponzi scheme victims, should have been well informed of Sentinel's leveraged investment strategy. A.48-49. As Sentinel customers testified, they received a variety of financial statements disclosing Sentinel's use of bank loans and repos. Tr.760-68, 793, 797, 812-13, 1501-11, 1517-24. And "a review of [Sentinel's] financial statements and forms 1-FR demonstrates that the loan interest was documented and that a significant portion of customer cash and securities that was to be 'segregated and held in trust' was pledged as collateral for the loan." A.48-49. Grede's contention (at 37) that the financial and reporting documents "concealed" the loan and repos from

Sentinel's customers cannot be reconciled with his claim that those same documents on their face disclosed Sentinel's fraud to BNYM.

In sum, Grede cannot circumvent his failure to prove actual fraudulent intent by invoking an unsupported—and insupportable—presumption.

C. Grede failed to prove actual fraudulent intent through circumstantial evidence.

Where direct proof of actual fraudulent intent is lacking, plaintiffs may seek to prove it circumstantially through "badges of fraud." See *In re Frierdich*, 294 F.3d 864, 870 (7th Cir. 2002) (listing nine badges of fraud); 740 ILCS 160/5(b) (listing eleven badges of fraud). The district court explained that Grede presented evidence of "at most, one badge of fraud" (Sentinel's insolvency at the time of the transfers). A.50. The court found proof "missing" of "those 'badges of fraud' that are more likely to demonstrate fraudulent intent, e.g., whether the debtor retained control of the asset or transferred the asset to an insider; whether the debtor received consideration for the transfer; and whether the debtor made the transfer before or after being threatened with suit by creditors." *Id.*

Grede presented no witness testimony at trial addressing badges of fraud aside from insolvency. The undisputed fact that each of the challenged transfers was for reasonably equivalent value (collateral pledged for cash loans to Sentinel) undoubtedly explains why he did not bother. The court therefore properly ruled that Grede had not proven fraudulent intent via the traditional badges. A.48-52.

Unable to satisfy the badges of fraud test, Grede (at 38) calls it "unnecessary" and seeks to relegate guideposts developed by courts and legislatures over centuries to the dustbin of history. See *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 540-41 (1994) (today's "badges of fraud" originated in early English jurisprudence). Grede (at 39-40) seeks to substitute a new rule that *any* contemporaneous wrongdoing makes a transfer fraudulent. That non-sequitur has no support in the law and again is simply Grede's attempt to escape his burden to prove rather than presume fraudulent intent. But as the Supreme Court has told federal courts, any expansion of a cause of action "is for Congress, not for us." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 165 (2008).

Moreover, Grede offers no alternative circumstantial evidence. He simply proclaims (at 39) "overwhelming, unrebutted evidence of fraud" and argues in circular fashion (at 39-40) that "Sentinel's fraud was independent circumstantial evidence of Sentinel's intent." In other words, Grede reiterates his rejected argument for *direct* evidence of fraudulent intent to support his argument for *circumstantial* evidence of such intent. But he has not shown how possible misuse of the proceeds of BNYM's loan by Sentinel insiders supports the conclusion that collateral transfers in return for BNYM's loans were fraudulent. And above all, Grede has not shown that the district court clearly erred in finding his proof insufficient.

Finally, even apart from his failure to prove intent, Grede's fraudulent transfer claim fails because BNYM received Sentinel's transfers "for value and

in good faith." 11 U.S.C. §548(c). The district court did not reach this defense, but it is supported by the court's findings that Sentinel transferred the assets in return for BNYM's loans and that BNYM was unaware that Sentinel was improperly using customer funds to secure the loans. See *Bonded Fin. Servs. v. European Am. Bank*, 838 F.2d 890, 897-98 (7th Cir. 1988).

II. The District Court Properly Rejected Grede's Equitable Subordination Claim.

Grede seeks to equitably subordinate BNYM's secured claim pursuant to 11 U.S.C. §510(c). As the district court noted, equitable subordination is "an extraordinary remedy" that should be invoked "only in extreme circumstances" involving "a clear inequity." A.56; see *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1356 (7th Cir. 1990) (cases equitably subordinating non-insider claims are "few and far between"); accord *First Alliance*, 471 F.3d at 1006. The court properly rejected Grede's claim after finding that BNYM did not engage in egregious misconduct of a type that could warrant this extreme remedy.

A. BNYM did not behave inequitably.

Equitable subordination has been applied primarily to a debtor's insiders or fiduciaries. *Kham*, 908 F.2d at 1356 ("Equitable subordination usually is a response to efforts by corporate insiders to convert their equity interests into secured debt in anticipation of bankruptcy"). Where, as here, "the claimant is not an insider, then evidence of more 'egregious conduct' such as fraud, spoliation or overreaching is generally required." 4 COLLIER ON BANKRUPTCY ¶510.05[4] (16th ed. 2011). See *First Alliance*, 471 F.3d at 1006 (requiring

"gross and egregious conduct" in non-insider cases); *In re Bowman Hardware & Elec. Co.*, 67 F.2d 792, 794 (7th Cir. 1933) (requiring an "act involving moral turpitude" or comparable misconduct). At a minimum, as the district court explained, Grede had to prove that BNYM "*knew* of or was *deliberately* indifferent to Sentinel's misconduct" before BNYM's secured claim could be equitably subordinated. A.64 (emphasis added). The court properly found that Grede failed to satisfy his burden.

Among the court's findings, made after reviewing and weighing voluminous evidence, including hours of recorded phone calls between BNYM and Sentinel employees, were the following:

- BNYM and Sentinel "had a relatively unremarkable ten-year relationship" that was "untroubled" prior to summer 2007. A.64-65.

- BNYM "had assurances from Sentinel that it was authorized to use customer securities for collateral, and customers were aware that Sentinel was using a leveraged trading strategy." A.65.

- BNYM could not see "movement of collateral to and from seg accounts, and it is unreasonable to expect that the Bank should have sought the information it needed to track each movement." *Id.*

- BNYM had no motivation to continue lending hundreds of millions of dollars to a customer engaging in misconduct simply to earn relatively small amounts of overnight interest. A.66.

- Bank employees had no motivation to facilitate misconduct by Sentinel and were unlikely to risk their jobs by continued lending to a client they knew was stealing from customers. *Id.*

- BNYM authorized the movement of $16 million from a lienable account to a segregated account—to its own detriment—even after Sentinel's collapse became likely. *Id.*

Based on these and other findings and careful credibility determinations, Judge Zagel concluded that BNYM and its employees "neither knew nor turned a blind eye to the improper actions of Sentinel" (A.70) and that "*[n]egligence* *** *is the most that can be said* of the conduct at issue." A.82 (emphasis added).

Moreover, abundant evidence showed that BNYM did not collude or act in bad faith with Sentinel, did not know of or even suspect impropriety by Sentinel, and never deviated from standard procedures in handling the Sentinel relationship. To the contrary, the evidence showed:

- BNYM had good reason to trust Sentinel. Its initial due diligence showed that Sentinel had been active for 18 years, Harris Bank and other institutions "thought highly" of it, and Sentinel's repo counterparties included reputable firms that would have performed their own due diligence. Tr.601-03.

- BNYM took "comfort" from the fact that Sentinel was audited and regulated by the CFTC, NFA, and SEC. Tr.2644-45; A.26-27. Grede's expert testified that Sentinel received "once a year surprise custody audits" by an independent public accountant, an SEC requirement. Tr.1691-92. And Sentinel's outside auditor testified that the CFTC was well aware of Sentinel's business model,

including its use of leverage, and never raised an issue about it. Tr.2287.

- BNYM also took comfort from the sophistication of Sentinel's clients. Tr.2644-45. According to Sentinel's former Sales Manager, prospective clients frequently received copies of Sentinel's audited financial statements (Tr.2317-18), as the clients testified themselves. *E.g.*, Tr.745, 1518. Sentinel's clients also received frequent documentation showing Sentinel's use of repos, bank loans, and leveraged investing. *E.g.*, Tr.760-61, 2340-41.

- Sentinel's leveraged investment strategy brought its customers above-market returns for years. Tr. 1896-1901, 1909.

- There was nothing unusual about the account structure set up by BNYM for Sentinel. According to Allen Clark, former head of BDS at JPMorgan Chase (BNYM's chief competitor), these accounts were "exactly the types that would be set up at JPMorgan." Tr.2008. Nor is it "unusual for clients to transfer securities between segregated accounts and a lienable account," including "hundreds of millions of dollars" worth. Tr.946.

- Account transfers are driven by instructions received from clearing customers, and banks rely on customer warranties of compliance with their segregation requirements. Tr.2020-21 (Clark). It is "the client's responsibility" to ensure that "the activity flowing through the clearance account is properly accounted for" because "[t]hey are warranting to us that they know which pieces of collateral belong to clients, which belong to the firm, which can be pledged, which cannot be pledged." Tr.620-21. Account managers do not "determine which specific securities are being moved from the segregated account to the lienable account" because "[i]t's the

client's instructions that we go by." Tr.945. At Harris Bank, Grede's expert Charles Hohman "relied on the FCM to know when it was allowed to move assets out of segregation." Tr.1649. Indeed, according to Clark, it would have been contrary to industry practice for BNYM to approach Sentinel's customers or regulators to verify that Sentinel's settlement activity was authorized; in years in the industry he had "never seen that done." Tr.2076-78.

- The evidence showed that BNYM employees did not suspect misconduct until after Sentinel collapsed. See Tr.2634 (in Rogers' dozens of conversations with colleagues about Sentinel between 2004-2007, no one ever indicated that Sentinel might be using its loan for an improper purpose); Tr.1235 (BNYM learned that Sentinel's principals were being accused of misconduct "after the bankruptcy filing"). The increase in Sentinel's loan beginning in 2004 resulted from Sentinel's increased use of leverage when it expanded and gained hedge fund accounts. Tr.410-12. Such "growth in borrowing is something that we typically see when a client employ[s] a successful business plan." Tr.2054 (Clark).

- There was nothing suspicious about how BNYM handled Sentinel's account during summer 2007. Bank meetings focused on Sentinel's need to reduce the loan balance and on BNYM's need to secure its loan with quality collateral. Tr.1382. When the loan spiked in June, BNYM did not shut Sentinel down because "we were told it wasn't a Sentinel problem, it was a repo counterparty problem. So by going along with Sentinel and keeping the loan as standing [and] working with them as they tried to find an alternate source of liquidity for that collateral [because] we wanted Sentinel to survive." Tr.1202. As industry expert Clark explained, it was "reasonable for the bank to continue to clear for Sentinel during

the summer of 2007" because "they had a 10-year relationship with these folks that you don't walk away from in [a] heartbeat." Tr.2075.

- Bank employees had no motive to avert their eyes from any wrongdoing because, to avoid any "conflict," their compensation was not tied to generation of credit revenues. Tr.554-55, 1216-17.

- On July 30-31, Sentinel made transfers that significantly reduced both the quality and quantity of collateral subject to BNYM's lien. A.42-43(SOF¶¶149-50). As industry expert Clark explained, these transfers show that BNYM "was willing to accept a lesser quality of security [and] not trying to enrich itself." Tr.2067.

- In August 2007, when Sentinel's problems escalated, BNYM again authorized transfers that harmed its own position. It transferred collateral back into segregation at Sentinel's request. Tr.667; BTX299. BNYM also allowed securities from the lienable Euroclear account to be sold based on Bloom's representation that they were SEG 1 collateral, which "decreased" BNYM's "overall collateral position." Tr.673.

This evidence shows that BNYM's loan transactions with Sentinel were designed to *assist* Sentinel and help keep it going through the rough summer of 2007, not to harm Sentinel's customers. Indeed, it would have made no sense for BNYM to continue lending money to a company it suspected of fraud when it could have called its oversecured loan at any time. See *Continental Bank, N.A. v. Everett*, 964 F.2d 701, 703 (7th Cir. 1992) ("A bank making a commercial loan depends largely on the success of the business for repayment"). Grede responds to this and other evidence by pointing to still

other evidence that he thinks supports his position and to argue that the district court should have weighed the evidence differently. But Grede made and lost his case at trial and does not get a replay on appeal. Grede further contends that BNYM acted inequitably by breaching duties allegedly owed under the CEA (Grede Br. 43-47), breaching alleged common law duties (*id.* at 47-49), and seeking and obtaining an unfair advantage (*id.* at 49-51). We address each of these arguments in turn.

B. BNYM breached no duties under the CEA.

Grede contends that BNYM breached duties purportedly owed under the CEA. The district court ruled that (i) Sentinel was effectively an FCM and thus required to segregate customer assets pursuant to CEA §6d(a); and (ii) BNYM had an independent duty to segregate pursuant to CEA §6d(b); but (iii) BNYM did not violate that duty. A.77-78.

BNYM disagrees with the district court's view that the §6d(a) segregation requirements applied to Sentinel. That provision applies by its terms only to FCMs. 7 U.S.C. §6d(a)(2). The statute defines an FCM as an entity "*engaged in* soliciting or in accepting orders for the purchase or sale of any commodity for future delivery." 7 U.S.C. §1a(20) (emphasis added). It is undisputed that Sentinel never engaged in such activities. A.24(SOF¶8); A.77 n.16; BTX850-66. The court thought it sufficient that Sentinel registered as an FCM. A.77. But the statute requires *engagement* in commodity futures trading, not just registration, for the segregation obligation to apply. See *New York Currency Research Corp. v. CFTC*, 180 F.3d 83, 89-90 (2d Cir. 1999) (CEA's books and

records requirements apply only to person both registered and functioning as commodity trading advisor). As CFTC staff put it in a 2003 memo, Sentinel's registration as an FCM was simply "a fiction" that allowed its "FCM clients to have their commingled clients funds treated as 'receivables' for net capital purposes." BTX859.3.

Nor did the CEA's segregation requirements apply to BNYM. The district court thought they did pursuant to CEA §6d(b). A.77-78. That provision makes it unlawful for "any depository that has received any money, securities, or property for deposit in a separate account as provided in [Section 6d(a)(2)], to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant." 7 U.S.C. §6d(b). That language expressly applies only to an FCM-depository relationship. Sentinel was never an FCM (see above), and only Sentinel, not its FCM customers, had the subject depository accounts at BNYM and the authority to move assets among them.[4]

But even if the CEA segregation requirements did apply to Sentinel and BNYM, the court properly ruled that BNYM did not violate them. Section 6d(b)

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[4] Amicus CFTC (at 11) claims that BNYM is administratively "estopped" by its segregation letters with Sentinel from denying that §6d(b) applied to it. The CFTC cites no authority for the notion that administrative estoppel applies to representations not made to an administrative agency. Further, as Judge Zagel explained, estoppel applies only "when 'a victory' is obtained," and "[s]igning a routine acknowledgment letter required by a CFTC regulation does not strike me as a victory." A.12. Moreover, the referenced letters state that "the funds ***in*** [the segregated] accounts will not be subject to [the Bank's] lien or offset" (SA1, 3) (emphasis added), an obligation with which BNYM indisputably complied. A.78.

does not prohibit depositing FCMs from moving assets from segregated accounts to lienable accounts if sufficient assets remain segregated to meet customer obligations. See *Securities Representing Investment of Customer Funds Held in Segregated Accounts by Futures Commission Merchants*, 62 Fed. Reg. 42398, 42398 (CFTC Aug. 7, 1997) ("prudent and efficient funds management typically requires an FCM to make frequent transfers *** into and out of segregation"). Thus, if a segregated account was over-segregated, Sentinel could lawfully transfer assets out of it. See 17 C.F.R. §1.23 (FCMs may "draw upon" their "residual interest" in any balance exceeding segregation obligations). Section 6d(b) simply bars banks from asserting a lien on customer assets in segregated accounts to offset a debt not incurred by the customer. Here, as Judge Zagel found, BNYM "placed no liens on any of the segregated accounts." A.78.

Grede argues (at 44) for an expansive interpretation of §6d(b) that would bar bank liens on customer assets that the FCM had transferred out of segregation. But as the district court noted, "[n]either Trustee nor CFTC cite authority" for their view that "once the funds meant to be segregated are deposited, they can only be used for the customer's own benefit." A.78. Grede (at 44) relies on the CEA's supposed "purpose," but if Congress intended such a broad prohibition, it presumably would have said so. See *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) (presuming that "a legislature says in a statute what it means and means in a statute what it says").

As amicus CFTC explains, the CEA authorizes transfers out of segregated customer accounts for a variety of purposes. CFTC Amicus Br. 19-20, citing 7 U.S.C. §6d(a)(2); 17 C.F.R. §1.23. The CFTC therefore concludes, as it must, that "***a depository can comply with an FCM's instructions to transfer funds from a segregated customer account without violating section 6d(b)***." CFTC Amicus Br. 20 (emphasis added). There is an exception, according to the CFTC, if "the depository knows or has reason to know" that the amount of the transfer exceeds the amount required to be kept segregated. *Id.* at 21. Here, the district court found that BNYM did *not* know that the transfers left the segregated accounts under-segregated and therefore did not violate the CEA under the CFTC's first exception. A.74, A.80.

That finding was well supported because BNYM had no way of knowing whether Sentinel was properly segregated. BNYM never had access to Sentinel's daily segregation calculation and did not perform daily valuations of collateral in segregated accounts, instead simply valuing securities in lienable accounts to ensure it was overcollateralized. A.34(SOF¶¶72-74). Moreover, BNYM never received copies of account statements for Sentinel's segregated customer cash accounts at JPMorgan Chase, which had monthly balances averaging in the hundreds of millions of dollars. Tr.291-92; A.37(SOF¶¶102-07); BTX817A.

The CFTC offers no statutory support for the additional "reason to know" exception it proposes, which it admits (at 21) amounts to an imposition of "inquiry notice" on banks. Such an inquiry notice standard is impracticable and would require minute-by-minute monitoring. Such monitoring is not viable

given the number, speed, and complexity of electronic transactions and the variety of customers and securities at issue. See Tr.562 (BNYM clears daily "about 150,000 transactions, on average," which "can spike up to 600,000 or so"); *id.* at 586 (BNYM does not review daily trading activity of clearing customers before approving overnight loans because there are "hundreds of thousands of transactions going through the accounts").

As industry expert Allen Clark testified, it also is "impossible" to "analyze the trading activity of *** clients" because "the electronic securities are as close to fungible as anything can possibly be"—"only *** a little less fungible than cash." Tr.2068-69. Thus, "[i]t's not possible to know all of the transactions that have taken place with your client or *** the downstream clients," and "the location of a security, namely whether it's in a segregated or nonsegregated account," does not "tell the clearing bank anything about the ownership status of that security." *Id.* at 2021-22, 2025. See also Tr.2643 (BNYM did not monitor how borrowers used loan proceeds because it's "virtually impossible to know exactly how a client is using its money"). Given those realities, it is "industry custom and practice to rely on customers' instructions regarding the movements of collateral into and out of different accounts" because banks "can't possibly presume to know what their intention is, what their transaction book looks like, what their interaction with their downstream clients, or counterparties for that matter, is." 2043-44 (Clark).

In these circumstances, the monitoring and inquiry duty posited by Grede and the CFTC would be unduly burdensome and costly. See *Bonded Fin.*

Servs., 838 F.2d at 893 ("The potential costs of monitoring and residual risk are evident when the transferees include banks and other financial intermediaries"). Indeed, Grede was able to uncover Sentinel's alleged misconduct only by deploying a small army of forensic analysts who spent literally thousands of hours on a comprehensive investigative mission. Tr.272-76. The proposed inquiry standard also would subject banks to liability each time an FCM violated its segregation obligations. In contrast, the statutory bright line recognized by the district court, which simply bars banks from liening assets in segregated accounts, is true to the CEA's text and provides clear notice and direction to banks, FCMs, customers, and regulators. If Grede and the CFTC desire more expansive obligations, they should seek them from Congress. See *Board of Gov. of Fed. Reserve Sys. v. Dimension Fin. Corp.*, 474 U.S. 361, 368-69 (1986) (rejecting federal agency's attempt to broaden scope of federal banking statute). The CFTC cannot retroactively impose such duties by means of an amicus brief. See *Keys v. Barnhart*, 347 F.3d 990, 993-94 (7th Cir. 2003) (agency briefs are entitled to little or no deference).

Lacking statutory support, *Grede* (at 45) cites a 1979 CFTC staff Interpretive Letter (SA.95), for which he (but not the CFTC) claims *Chevron* deference. But *Chevron* deference does not apply to such interpretive letters. *Gryl v. Shire Pharm. Group PLC*, 298 F.3d 136, 146 n.8 (2d Cir. 2002). Moreover, the letter suggests only that a bank "with prior notice" of such misappropriation by FCMs could violate the CEA's segregation provisions (and admits that the agency could find "no case law" to support even that view).

SA.96-97. In other words, according to the letter, a bank would have to *know* of such misappropriation before the bank could be subject to liability. Again, the district court found that BNYM did *not* know of Sentinel's misconduct, making the letter off-point.

Grede (at 46) cites another CFTC staff letter, this one to Sentinel in 2006 (SA.30-32), which actually refutes Grede's view of a bank's CEA duties. The letter provides that the parties' custody accounts "require BONY to segregate the funds ***in** the Seg I and Seg III accounts* from BONY's own assets and prohibits BONY from using the funds ***in** the Seg I and Seg III accounts* for BONY's own purposes." SA.31 (emphasis added). It is undisputed that BNYM complied with these requirements at all times. A.74.

Grede additionally contends that, in "the Seg letters," BNYM "acknowledged and agreed to be bound" by the CEA. Grede Br. 44, citing SA.1-4. The district court agreed but rightly found no breach. A.80. In fact, these letters were not contracts. The regulations provide that when an FCM deposits "customer funds" with a bank, it must obtain the bank's "written *acknowledgment* [that] it was informed that the customer funds deposited therein are those of commodity or options customers and are being held in accordance with the provisions of the Act." 17 C.F.R. §1.20 (emphasis added). Such an "acknowledgment" is not a contract that imposes duties. That was not always the case. Rule 1.20 had originally required "a written *agreement* *** waiving any claim, lien, or right of set-off." 17 C.F.R. §1.20 (1967) (emphasis added). The purpose of the change from "agreement" to "acknowledgment" was

"to remove the provisions regarding the need to secure waiver agreements from depositories." *General Regulations under Commodity Exchange Act*, 33 Fed. Reg. 7240, 7242 (1968). This history confirms that segregation letters are not contracts.

Finally, even if BNYM violated the posited CEA duties, that cannot have constituted the type of *egregious* misconduct required for equitable subordination. According to the CFTC (Amicus Br. 2), its interpretation of the CEA's segregation requirements raises an issue "of first impression." The CFTC thereby admits that no existing authority supports its view of the statute, and Grede offers none. BNYM's failure to adhere to supposedly expansive duties under a statute that neither expressed such duties nor had been interpreted to require them is far from egregious misconduct.

C. BNYM breached no "common law" duties.

Grede claims (at 47) that BNYM breached a common-law "duty of inquiry," relying on *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273 (2d Cir. 2006). But *Lerner* simply reversed a dismissal on the pleadings of claims relating to assets misappropriated from fiduciary accounts. There, defendant banks allegedly failed to detect an attorney-run Ponzi scheme involving overdrawn customer trust accounts, with the alleged facts showing that the "sole inference" available to the banks was that the attorney intended to misappropriate trust funds. *Id.* at 288. Here, by contrast, the evidence at trial showed that misconduct was far from the sole inference available to BNYM from Sentinel's account activity, which in fact led BNYM to worry solely about the security of

its loan. Tr.1235, 2634. Moreover, as Judge Zagel explained, *Lerner* involved "a negligent failure to detect misappropriation, which [Grede] admits is insufficient for equitable subordination." A.82. Finally, an FCM's accounts are very different from the fiduciary accounts in *Lerner* because an FCM may remove assets from segregation for his own use. 17 C.F.R. §1.29 (FCMs may keep earnings from investment of customer funds).

Grede's common-law duty argument also is preempted by the Uniform Commercial Code. Pursuant to UCC §8-503(e), which governs common-law claims involving a "securities intermediary" (Sentinel), there can be no cause of action against "any purchaser of a financial asset" (including a lender like BNYM) who "does not act in collusion with the securities intermediary." Grede offered no evidence of any collusion between BNYM and Sentinel, and Section 8-503 must be given effect given the lack of any conflict with the Bankruptcy Code. See *In re Wright*, 492 F.3d 829, 832-33 (7th Cir. 2007) ("rights under state law count in bankruptcy unless the Code says otherwise").

Grede's "duty of inquiry" also founders on the fact that other entities—with professional duties and/or substantial incentives to detect any wrongdoing by Sentinel—discovered nothing despite having at least as much information as BNYM. In fact, prior to the 2007 crisis, the repo counterparties increased their combined credit lines to Sentinel to more than $2 billion (BTX102, 130, 149), the auditors certified Sentinel's financial disclosures (TTX85, 118, 120, 165, 225), the regulators gave Sentinel additional no-action relief (TTX93A), and Sentinel's customers tripled their investments (BTX847).

These were contemporaneous, objective indicia to BNYM that Sentinel ran a legitimate business. Grede theorizes that BNYM should have been a better regulator than the CFTC or NFA, a better auditor than McGladrey, a better lender than FIMAT or Cantor Fitzgerald, and more vigilant about protecting Sentinel's customers than the customers themselves. Grede's expert, Charles Hohman, epitomized that skewed view by opining that "everyone missed it except the Bank of New York." Tr.1699. The district court properly rejected the notion that a clearing bank had a duty to monitor and uncover misconduct that government regulators, professional auditors, institutional repo counterparties, and sophisticated customers did not. See *HA2003 Liquidating Trust v. Credit Suisse Sec. (USA) LLC*, 517 F.3d 454, 457 (7th Cir. 2008) (explaining that the "division of labor" between auditors and banks "has large benefits for an economy, as it allows specialists to do what they are best at").

Grede also suggests (at 47) that BNYM had a common-law duty not to lien funds received for "special deposit." But even if the segregated accounts qualify as special deposits (and if the CEA is not preemptive with respect to such accounts), BNYM cannot have breached any such duty because it never liened any assets in segregated accounts. A.78.

D. BNYM did not obtain an "unfair advantage."

Grede contends (at 49-50) that BNYM sought and obtained an unfair advantage over unsecured creditors by insisting on high-quality collateral for its secured loan in summer 2007. But BNYM had no obligation—in the face of Sentinel's requests for loan increases—to lend against illiquid securities of

indeterminate value. Consistent with its clearing lending practices generally, BNYM insisted on investment-grade collateral. Requiring good collateral is just good banking, especially at a time of market uncertainty. See *Kham*, 908 F.2d at 1358 (a bank "is not an eleemosynary institution"). If Sentinel's insiders used loan proceeds improvidently, such as by repurchasing illiquid "leftover" securities (Grede Br. 50), that does not mean that BNYM's requirement of quality collateral for cash advances was unfair.

In fact, BNYM's collateral requirements did not disadvantage Sentinel's customers. "Only misconduct that harms other creditors will suffice" for equitable subordination. *In re Kreisler*, 546 F.3d 863, 866 (7th Cir. 2008); see *In re SI Restructuring*, 532 F.3d 355, 361 (5th Cir. 2008) (equitable subordination requires "actual harm"); accord 4 COLLIER ON BANKRUPTCY, *supra* p. 33, ¶510.05[5][a]. BNYM provided full value in exchange for pledged securities (A.54-55), and a Sentinel liquidation at any time prior to the challenged transfers would have "made the bank whole." Tr.1203. Thus, the transfers did not deplete Sentinel's estate. See *Batlan v. Transamerica Comm'l Fin. Corp.*, 265 F.3d 959, 972 (9th Cir. 2001) (payments to fully secured creditors do not deplete estate); *In re Submicron Sys. Corp.*, 432 F.3d 448, 462 (3d Cir. 2006) (rejecting equitable subordination because unsecured creditors were unharmed by asset sale that prevented immediate liquidation).

Grede also complains (at 49) about the discount, or "haircut," that BNYM applied to DTC securities pledged by Sentinel. But such discounts are standard in overnight lending (Tr.948, 2517), and Grede points to no evidence of

anything improper about the discounts applied by BNYM. Nor was there anything "unfair" about BNYM's asserting its rights as a secured creditor when Sentinel failed, as Grede charges (at 49-50). The very reason banks and other entities obtain collateral is to be prepared for borrower failures. A bank is "entitled to advance its own interests" over those of "other creditors." *Kham*, 908 F.2d at 1358.

Moreover, the sophisticated nature of Sentinel's investors bears on any "unfairness" calculus. These FCMs, hedge funds, and other institutions chose to invest tens, sometimes hundreds, of millions of dollars of their customers' and their own money with a thinly-capitalized money manager. See A.36(SOF¶¶95-97). With some $1.5 billion invested, they had plenty at stake and plenty of reason to be diligent. They should not get free insurance for making a bad bet. See *Kham*, 908 F.2d at 1357 (courts should not protect commercial parties "who do not protect themselves"); *Sharp Int'l*, 403 F.3d at 53 (there was no "duty on [the bank's] part to precipitate its own loss in order to protect lenders that were less diligent").

Finally, the evidence shows that Sentinel's collapse was due to Sentinel's investment decisions coupled with the financial crisis in spring and summer 2007. Tr.1834-35, 1840-41, 1855, 2854–25. BNYM had nothing to do with Sentinel's decision to purchase financial sector securities or CDOs or with the repo counterparties' decisions to return such securities to Sentinel. The extraordinary remedy of equitable subordination does not apply to such third-party conduct. See *In re Baker & Getty Fin. Servs., Inc.*, 974 F.2d 712, 718-19

(6th Cir. 1992) (equitable subordination unwarranted even if bank's lending practices were not "sound or prudent" where creditors' harm was due to "debtors' actions") (citation omitted).

E. Grede's argument for a negligence standard is unsupported and meritless.

As explained *supra* pp. 33-34, courts do not equitably subordinate bankruptcy claims of non-insiders unless the conduct at issue is "gross and egregious, tantamount to fraud, misrepresentation, overreaching or spol[i]ation or involving moral turpitude." *In re Granite Partners L.P.*, 210 B.R. 508, 515 (Bankr. S.D.N.Y. 1997); see *Stratton v. Equitable Bank, N.A.*, 104 B.R. 713, 730 (D. Md. 1989) (conduct that "shocks the conscience" of the court required for equitable subordination); COLLIER ON BANKRUPTCY, *supra* p. 33. Unable to prevail under the established standard, Grede (at 50) argues instead for an "objective," "reasonable person" standard. In other words, Grede contends that mere negligence should suffice for equitable subordination. See *Desnick v. Am. Broadcasting Cos.*, 233 F.3d 514, 518 (7th Cir. 2000) (equating negligence and "reasonable person" standards). No court has ever accepted a negligence standard for equitable subordination. "Inequitable conduct sufficient to support equitable subordination cannot be based on mere negligence." *Maryland Nat'l Bank v. Vessel Madam Chapel*, 46 F.3d 895, 901 (9th Cir. 1995); see *Kreisler*, 546 F.3d at 866 (no equitable subordination unless claimant was "guilty of misconduct"). Grede offers no reason why the established standard should be dramatically lowered for this case.

The district court rejected Grede's argument, explaining that "a lack of care does not rise to the level of the egregious misconduct necessary for equitable subordination." A.65. Judge Zagel noted that the cases cited by Grede "do not" support use of an objective standard because they "addressed creditors that willfully engaged in inequitable conduct." A.70. Moreover, an objective standard would "not fit well with the concepts of inequity and misconduct" on which the equitable subordination doctrine rests. A.72. At most, the court concluded, "[t]here has to be an element of 'should' rather than could," and "[i]n the circumstances of this case I am persuaded that the bankers had no legal obligation—no 'should'—to seek out or analyze the data which the Trustee claims would have led it down the correct path." *Id.*

Grede fails to refute that reasoning or cite any case applying a "reasonable person" standard to equitable subordination. He first relies (at 51) on *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), a seminal equitable subordination case that reversed the subordination of insider claims and makes clear that equitable subordination requires "knowing" misconduct.

In *Mobile Steel*, the trustee asserted that insiders improperly issued debentures that were actually preferred stock. *Id.* at 695. The "operative facts" involved the insiders' "*knowing* undercapitalization" and "attendant unfairness to the creditors." *Id.* at 702 (emphasis added). Thus, the issue was what the insiders *knew* about the purported undercapitalization, not what reasonable persons would have known. The court applied a "reasonably prudent men" standard in its inquiry about "the amount of capitalization that is adequate" for

a newly established enterprise, not to any determination of inequitable conduct. *Id.* at 703. In the end, the Fifth Circuit did not decide whether the insiders behaved inequitably because it found the corporation adequately capitalized. *Id.* Thus, *Mobile Steel* does not support Grede's proposed objective standard.

Grede makes the same mistake (at 51) with respect to *In re Lifschultz Fast Freight*, 132 F.3d 339 (7th Cir. 1997), which also focuses on undercapitalization. This Court reiterated that "equitable subordination is predicated upon creditor *misconduct*," such as "*deception* about the debtor's financial condition." *Id.* at 348-49 (emphasis added).

Other courts, too, uniformly focus on the mens rea of the creditor. *E.g.*, *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 229 (1948) (equitable subordination requires "the unconscionable use of the opportunity" to harm other creditors); *In re Pacific Express, Inc.*, 69 B.R. 112, 118 (B.A.P. 9th Cir. 1986) (rejecting equitable subordination claim against lenders absent evidence of "overreaching, fraud" or similar conduct). Thus, in *In re Baker & Getty Financial Services, Inc.*, 974 F.2d 712, 718 (6th Cir. 1992), the court refused to subordinate a bank's claim, notwithstanding its significant irregularities, because "[w]here the claimant is a non-insider, egregious conduct must be proven with particularity," and there was no evidence that the bank or its officers believed they were acting wrongly. In contrast, the court in *Matter of Fabricators, Inc.* found equitable subordination warranted based on "specific

findings concerning [the lender's] *knowledge*." 926 F.2d 1458, 1463 (5th Cir. 1991) (emphasis added).

Grede's assertion (at 52) that a subjective standard requiring knowledge or intent is "unachievable" cannot be reconciled with these cases. Grede says this standard "makes no sense" because of purported difficulties in determining corporate intent. But courts frequently determine corporations' subjective intentions, as in the context of securities fraud claims. *E.g.*, *Matrixx Initiatives, Inc. v. Siracusano*, 131 S.Ct. 1309 (2011); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007). And the Supreme Court expressly rejected some courts' views that negligence sufficed to make corporations and other entities liable on such claims. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

While Grede's proposed negligence standard might be a boon to bankruptcy trustees, it inevitably would burden the courts and the economy. As this Court has observed, unlike managers of a going concern, "the trustee of a defunct business has little to do besides filing claims that if resisted he may decide to sue to enforce. Judges must therefore be vigilant in policing the litigation judgment exercised by trustees in bankruptcy." *Maxwell v. KPMG LLP*, 520 F.3d 713, 718 (7th Cir. 2008). Judge Zagel exercised such vigilance by denying equitable subordination based merely on contentions that a non-insider lender failed to act "reasonably."

With no support for his negligence standard, Grede alternatively argues (at 53-54) that "willful blindness" should be enough for equitable

subordination. But the district court found nothing *willful* about BNYM's failure to unearth Sentinel's misconduct, instead expressly finding that BNYM and its employees "neither knew *nor turned a blind eye* to the improper actions of Sentinel." A.70 (emphasis added).

Grede (at 54-55) challenges that finding by accusing BNYM's witnesses of lying. He rejects the court's credibility determinations that "the witnesses were not covering up wrongdoing, but were rather worried about the professional consequences of their failure to look more closely at the situation as it unfolded." A.69. Grede (at 55) calls these findings "speculation." But that simply reflects his consistent refusal to accept the standard of review, which makes such credibility determinations virtually unchallengeable on appeal because of the trial court's superior position to evaluate live witness testimony. See *supra* pp. 22-23. As Judge Zagel noted, "this is why we have live witnesses and why I listen to them carefully and watch them carefully." Tr.2238.

Grede's flouting of the standard of review is underscored by his contention (at 56) that this Court should accept *his* inferences over the district court's. That is a trial—not an appellate—argument. Grede cannot substitute *his* speculation for the district court's trial findings.[5]

[5] Despite Grede's hyperbolical claims about losses to Sentinel's customers, the magnitude of any arguable injury would be *at most* $40-66 million, depending on the appropriate trigger date, as the district court explained based on calculations by BNYM's expert. A.87-88. Grede (at 56-57) offers no viable reason to demand subordination of the entire amount of BNYM's final lien.

III. The District Court Properly Rejected Grede's Contention That Contracts Underlying BNYM's Security Interest Were Illegal.

Grede contends (at 57-59) that the district court erred by dismissing his claim that Sentinel's contracts were inherently illegal. On that basis, he seeks a ruling, pursuant to 11 U.S.C. §506(d), that BNYM lacked a valid security interest and seeks recovery of the over $300 million BNYM received on its secured claim.

The district court properly dismissed Grede's illegal contracts claim. As Judge Zagel explained, Grede complains only about "what was done in administering the contracts," in particular transfers between segregated and lienable accounts, not the contracts themselves. A.18. A contract is not illegal simply because a party allegedly *abused* it. *Northern Ind. Pub. Serv. Co. v. Carbon County Coal Co.*, 799 F.2d 265, 273 (7th Cir. 1986) ("[T]he defense of illegality does not come into play just because a party to a lawful contract *** commits unlawful acts to carry out his part of the bargain"). Moreover, "contracts and other written instruments will be construed to avoid a possible violation of law." *Nat'l Van Lines, Inc. v. United States*, 355 F.2d 326, 332 (7th Cir. 1966); accord *Perry Coal Co. v. N.L.R.B.*, 284 F.2d 910, 914 (7th Cir. 1961).

Here, there was nothing inherently illegal about the account agreements. CFTC rules expressly authorize FCMs to transfer assets from segregated accounts. 17 C.F.R. §1.23; see also 17 C.F.R. §1.29 (FCMs may keep earnings from investment of customer funds). Nothing in the contracts made it impossible for Sentinel to comply with segregation requirements. Hence, as the district court explained, "[e]ven the most generous reading of the complaint

alleges solely that the contracts were not well suited to Sentinel's business and that they were badly administered." A.18.

Grede cites *U.S. Nursing Corp. v. Saint Joseph Medical Center*, 39 F.3d 790 (7th Cir. 1994). But as the district court noted, *U.S. Nursing* addresses contracts by a servicing party that failed to obtain a required state license. A.17 n.12. "In such instances, the services that are the basis for the contract are, quite literally, performed unlawfully, and the contracts are therefore unenforceable as a matter of public policy." *Id.* Judge Zagel correctly ruled that *U.S. Nursing* and similar cases are "inapplicable" in this completely different factual context where it is undisputed that BNYM was legally eligible to act as a depository for FCM funds and Sentinel was registered with the CFTC. BTX1.2.

CONCLUSION

The district court's judgment should be affirmed

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH RULE 32

1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 13,863 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

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CERTIFICATE OF SERVICE

I, the undersigned attorney, certify that, on May 20, 2011, I caused a copy of the foregoing Brief of Defendants-Appellees The Bank of New York Mellon Corporation and The Bank of New York to be served on the following via ECF electronic filing and email.

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