

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION**

In re:) Chapter 11
)
SENTINEL MANAGEMENT GROUP, INC.,) Case No. 07 B 14987
)
Debtor.) Hon. John H. Squires
)
)

**OBJECTION TO BANK OF NEW YORK’S MOTION FOR AN ORDER PURSUANT TO
SECTION 362 OF THE BANKRUPTCY CODE GRANTING RELIEF FROM THE
AUTOMATIC STAY TO ALLOW THE BANK OF NEW YORK MELLON TO
FORECLOSE UPON ITS COLLATERAL, OR IN THE ALTERNATIVE, TO EXERCISE
ITS SETOFF RIGHTS**

Frederick J. Grede, the chapter 11 trustee (the “Trustee”) for the estate (the “Estate”) of Sentinel Management Group, Inc. (the “Debtor” or “Sentinel”), by and through his undersigned counsel, hereby objects to the relief requested in the Motion for an Order Pursuant to Section 362 of the Bankruptcy Code Granting Relief from the Automatic Stay to Allow the Bank of New York Mellon to Foreclose Upon Its Collateral, or in the Alternative, to Exercise Its Setoff Rights (the “Motion”) filed by Bank of New York (“BONY”). In support thereof, the Trustee respectfully states as follows:

PRELIMINARY STATEMENT

BONY’s Motion should be denied because BONY has not (and cannot) establish a basis for stay relief under § 362(d). The Trustee has proposed to create a cash reserve to adequately protect BONY’s alleged secured claim during the pendency of the “BONY Adversary Proceeding” (N.D. Ill. Case No. 08-02582), making relief under § 362(d)(1) inappropriate. In addition, BONY is not entitled to relief under § 362(d)(2) because there is absolutely no dispute that BONY is significantly oversecured, and thus BONY cannot prove one of the two elements

necessary for stay relief under § 362(d)(2). Tacitly recognizing that it has no basis to obtain stay relief, BONY makes two novel arguments, neither of which is supported by case law.

First, after repeatedly arguing to the Court that it was entitled to interest and fees under § 506(b) on its claim because it is oversecured, BONY now argues that the Debtor has no equity in the alleged collateral under § 362(d)(2). BONY is clearly trying to have it both ways. It does so by arguing that the Court should bifurcate its alleged collateral and find that BONY is exactly secured with respect to the current amount of its claim by the part of the collateral BONY defines as the “BONY Accrued Payoff Amount.” BONY claims the estate has no equity on that portion of the alleged collateral, thus allegedly justifying relief for BONY under § 362(d)(2). But seeking to “have its cake and eat it too,” BONY also maintains that the Trustee must preserve collateral beyond the BONY Accrued Payoff Amount to cover additional interest charges, attorneys’ fees and costs that may accrue. BONY cannot have it both ways – either there is no equity in the collateral in which case it is not entitled to any interest, fees or charges under § 506(b), or it is oversecured, in which case it cannot obtain stay relief under § 362(d)(2). The truth, as no one seriously disputes, is that if BONY’s liens and claims are upheld, BONY is heavily oversecured.

Second, BONY briefly suggests that “cause” for stay modification might exist under § 362(d)(1) even if the Trustee provides adequate protection for its disputed claim. BONY’s theory here appears to be that the Court should substitute BONY’s judgment for that of the Trustee and the Creditor’s Committee with respect to what is in the best interests of unsecured creditors, and force the Trustee to repay a claim that is heavily disputed. BONY cites no case law for this proposition, or any case law which finds that a creditor which has been provided

adequate protection in the form of a cash reserve is entitled to stay relief. The Court should deny the Motion on § 362(d)(1) grounds as well.

BACKGROUND

On August 17, 2007 (the “Petition Date”), the Debtor filed a voluntary petition for relief under chapter 11 of title 11 of the United States Code (the “Bankruptcy Code”). The Debtor was in the business of managing investments of cash for various clients, including commodity brokers, hedge funds, financial institutions, pension funds, and individuals.

Sentinel divided its customers into three groups and was supposed to strictly segregate the investments of these three customer groups from each other and from the Sentinel’s own funds. In the BONY Adversary Proceeding, the Trustee alleges that BONY established a fundamentally flawed account structure for Sentinel’s accounts in violation of its obligations under federal law, and its duties to Sentinel. This account structure: (1) commingled customer assets, which should have been segregated, with Sentinels’ own assets and the assets of other customers; (2) facilitated the misuse of customer assets as security for BONY’s loan to Sentinel; and (3) allowed BONY, on a daily basis, to apply the proceeds of virtually every securities transaction involving customer assets to pay down a portion of Sentinel’s debt to BONY.

In addition, the Trustee alleges that BONY aided and abetted breaches of fiduciary duty committed by certain Sentinel insiders and knowingly accepted fraudulent and preferential transfers as part of the Sentinel insiders’ scheme. The Trustee further alleges that BONY engaged in inequitable conduct including violating the Commodity Exchange Act and participating in violations of the Investments Adviser Act of 1940, by extending credit to Sentinel far in excess of any reasonable line of credit for Sentinel’s business, having actual knowledge that Sentinel did not have sufficient assets to secure that credit and would need to use customer assets to secure those loans, illegally transferring securities from segregated customer

accounts to a collateral account in order to secure its own loan, consistently preferring its own pecuniary interests as a lender to its obligations under federal law and its duty to segregate and hold in custody Sentinel's customer assets, and asserting liens over assets which it knew were intended to be segregated for customers.

In sum, in the BONY Adversary Proceeding the Trustee alleges that absent the unlawful account structure established by BONY, and BONY's other misconduct, Sentinel's collapse would not have occurred and Sentinel would not have suffered hundreds of millions of dollars in losses and increased liabilities. The BONY Adversary Proceeding is currently before Judge Zagel, and the Trustee is seeking damages exceeding \$550,000,000.

Securities and cash of the Debtor in which BONY asserts an interest are currently being held in restricted accounts pursuant to this Court's orders (Docket Nos. 320 and 328) dated December 13, 2007 and December 20, 2007 (the "Restricted Accounts"). According to BONY, as of July 22, 2008, the Restricted Accounts contained "approximately \$510 million in cash along with securities having a face value of approximately \$120 million." (Docket No. 741 at 3) The secured claim BONY asserts in the Motion stands at approximately \$335 million. (Motion ¶ 10)

OBJECTION

I. The Statutory Grounds for Relief From the Automatic Stay are Not Met.

BONY contends that it should be entitled to relief from the automatic stay alternatively under either § 362(d)(1) or (2) of the Bankruptcy Code. Those sections provide:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay --

(1) for cause, including lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if --

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

11 U.S.C. § 362(d)(1) and (2).

The decision whether to grant relief from the automatic stay “is committed to the sound discretion of the bankruptcy court.” *In re Pelham Enterprises, Inc.*, 376 B.R. 684, 689 (Bankr. N.D. Ill. 2007). Here BONY can satisfy neither the requirements of § 362(d)(1) nor (2), and its Motion should be denied.

A. BONY Cannot Establish that the Estate Lacks Equity in the Restricted Accounts under § 363(d)(2).

To justify relief under § 362(d)(2) the Court must find both that the “debtor does not have an equity in [the] property” and that it is “not necessary to an effective reorganization. Equity refers to “the difference between the value of the property and all encumbrances upon it.” *In re Highland Park Associates Ltd. Partnership I*, 130 B.R. 55, 57 (Bankr. N.D. Ill. 1991) (citations omitted). As the party requesting relief from the stay, BONY bears the burden of proving that the estate lacks equity in the Restricted Accounts. *See* 11 U.S.C. 362(g)(1); *see also Pelham Enterprises*, 376 B.R. at 689. BONY does not and cannot meet that burden.

In *United Sav. Ass’n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988), the Supreme Court equated determining whether the debtor had equity in collateral with determining whether the creditor was undersecured. *Id.* at 375 (stating that the movant must “establish[] that he is an undersecured creditor”). BONY readily admits that it is “substantially oversecured” (Motion ¶ 12), therefore it cannot satisfy its burden of proof on § 362(d)(2)(A).

BONY attempts to evade this glaring flaw in its Motion by suggesting that its alleged collateral should be bifurcated into (i) what it calls the “BNY Accrued Payoff Amount,” and (ii) all the rest. It then asks the Court only to consider the BNY Accrued Payoff Amount in determining whether there is equity. (Motion ¶ 19) The novel “equity analysis” that BONY proposes under § 362(d)(2) is both outcome driven and inconsistent with case law. As BONY has stated repeatedly, BONY asserts a security interest in *all* of the cash and securities in the Restricted Accounts, a sum far in excess of the “BNY Accrued Payoff Amount.” In determining whether the debtor has equity in collateral under § 362(d)(2), the Court must consider the value of the entire security package. *In re Opelika Mfg. Corp.*, 66 B.R. 444, 448 (Bankr. N. D. Ill. 1986).

In *Opelika*, a secured creditor (FNB) held security interests in (i) all the stock of a debtor subsidiary called Sew Simple; (ii) 75,000 shares of a debtor subsidiary called Hickory Furniture; (iii) the debtor’s machinery, equipment and accounts receivable; and (iv) substantially all of the assets of the debtor’s Sew Simple subsidiary. FNB sought to lift the stay solely as to the Sew Simple and Hickory Furniture stock (nos. (i) and (ii) above). *Id.* at 446. In rejecting FNB’s “no equity” argument, the Court held

Section 362(g)(1) basically requires a secured creditor to show that it is undersecured. In order to accomplish that, a secured creditor must show that the value of its *entire* security package is less than the debt due. If not, the debtor clearly has equity in the property and the creditor is precluded from receiving relief under § 362(d)(2). FNB has a package of security for its loans to [the debtor]. This package includes not only the pledged stock [which the lift stay motion addressed], but various security interests in other assets of [the debtor] and Sew Simple. *In determining whether [the debtor] has equity in the property under § 362(d)(2)(A), the Court must consider the entire security package, not just a portion thereof.*

Id. at 447-448 (emphasis added). The *Opelika* court went on to deny relief under § 362(d)(2) because, lacking evidence of the value of FNB’s security interests in the other collateral, it could not determine “whether [they] provide[d] FNB adequate protection” *Id.* at 448.¹

The court in *In re Colonial Center, Inc.*, 156 B.R 452 (Bankr. E.D. Pa. 1993) reached the same conclusion. Colonial Center involved a secured creditor (RTC) with mortgages on four parcels of real property, but the debtor owned only two. RTC sought relief from the stay as to those two. *Id.* at 458-59. The Court denied relief under § 362(d)(2). It declined to reach the question of whether the lien should be apportioned among the properties for purposes of the § 362(d)(2) equity analysis, or whether the value of all properties should simply be compared to the value of all liens, but it had no trouble rejecting the RTC’s argument that the stay should be lifted because the two properties subject to the stay relief request were worth less than the RTC’s claim. It concluded that because all of the properties were subject to the lien, all had to be considered in determining whether the debtor had equity in the ones it owned under § 362(d)(2). *Id.* at 461-62. Thus from the Supreme Court on down, it is clear that the question of “equity” under § 362(d)(2)(A) cannot simply ignore a portion of the collateral as BONY suggests. Indeed, BONY cites nothing to the contrary and the Court should reject its argument and deny the Motion.

¹ After rejecting § 362(d)(2) as a basis to lift the stay, the Court in *Opelika* did find “cause” to lift the stay under § 362(d)(1). But it did so at the creditor’s committee’s recommendation, and in what it described as “unique circumstances” because lifting the stay was necessary to effectuate a sale of the stock at what the court determined to be a price substantially in excess of fair value, and where the lender had committed to accepting the proceeds in full satisfaction of its claim. *Opelika*, 66 B.R. at 453. In addition, of course, *Opelika* did not involve a lender whose secured claim was heavily disputed.

B. BONY Cannot Established that Cause Exists for Relief from the Automatic Stay Under § 362(d)(1).

Section 362(d)(1) of the Bankruptcy Code provides that relief from the automatic stay may be granted “for cause, including the lack of adequate protection of an interest in property.” *See* 11 U.S.C. §362(d)(1).

BONY first argues that lack of adequate protection is not the only potential source of “cause” under § 362(d)(1), and makes an oblique one line reference to the possibility that the failure to pay BONY off could be detrimental to unsecured creditors. While BONY doesn’t say so, the only possible detriment to unsecured creditors BONY could be referring to is the accrual of interest on BONY’s disputed claim. BONY cites no authority for the proposition that this accrual constitutes “cause” for relief from the stay and the Court should disregard this throw-away argument. The Trustee, with a duty to maximize the estate’s value for creditors, and the Committee, made up of sophisticated institutions with sophisticated professionals, have each weighed the risk of this potential detriment against the likely costs in expense, delay, and potential resolution value of the BONY Adversary Proceeding and have each independently determined -- with eyes wide open -- not to provisionally repay BONY at this time. BONY’s sudden concern for the interests of unsecured creditors notwithstanding, the Court should defer to the representatives of, and fiduciaries for, those creditors, not to their adversary BONY, to determine where the interests of unsecured creditors lie.

BONY next suggests that “cause” exists because BONY lacks (or will lack, BONY is less than clear) adequate protection. It premises this argument entirely on the Trustee’s proposal of a reserve in connection with the Plan and/or the use of cash collateral. When examined, this argument doesn’t even make sense. First, there is no dispute that at the moment, BONY is adequately protected. BONY does not deny this, nor could it. As of July 22, 2008, BONY’s

alleged collateral, by its own admission, “consisted of approximately \$510 million in cash along with securities having a face value of approximately \$120 million.” (Docket # at 3) The secured claim it asserts in the Motion is only \$335 million. (Motion ¶ 10) That’s over a 50% equity cushion *just based on the cash*, and nearly a 90% equity cushion if the securities are taken at face value.

So BONY must be, and appears to be, complaining not that it is not adequately protected currently, but only that it *will not be adequately protected* if the Court either grants the Cash Collateral Motion or confirms the Plan. Here is why BONY’s argument makes no sense: the Court cannot, and presumably will not, grant the Cash Collateral Motion or confirm the Plan unless it determines that BONY is adequately protected.

With respect to the Cash Collateral Motion, this is explicit in § 363(e), and the requirement of adequate protection for use of cash collateral is not in dispute. With respect to the Plan, it will only be confirmed if the reserve to protect BONY’s asserted claim amounts to the “indubitable equivalent” of its claim, under § 1129(b)(2)(A)(iii). And under § 361(3), the provision of “indubitable equivalence” satisfies the standard for providing adequate protection.

In short, there is no threat to BONY’s currently unquestionable adequate protection. It will retain its presently extravagant level of protection unless the Court does one of two things, grant the Cash Collateral Motion or confirm the Plan. Neither of these is something the Court can or will do without first finding that BONY remains adequately protected. In the event the Court declines both, all of the cash and securities within the Restricted Accounts will remain and BONY will continue to be wildly oversecured. There simply is no scenario that leaves BONY without adequate protection.

C. In Light of BONY's Adequate Protection and the Serious Challenges to Its Liens and Claims, the Court Should Not Exercise its Discretion in Favor of Releasing Funds to BONY.

As explained above, there is no cause here for the Court to consider anything beyond the fact that BONY is oversecured and adequately protected in order to deny the Motion. But if the Court is inclined to give any credence to BONY's "bifurcated collateral" theory, or its suggestion that the accrual of disputed interest on a disputed claim may constitute "cause" under § 362(d)(1), then the Court should also give consideration to the substantial uncertainty surrounding BONY's ultimately secured status as yet another reason to exercise its discretion in favor of denying the Motion. *Pelham*, 376 B.R. at 689. Where, as here, BONY is concededly vastly oversecured; there are serious and substantial questions about whether its allegedly secured position will survive the BONY Adversary Proceeding; and there is no threat to its security position if it does, there is no reason for the Court to allow BONY's loans to be repaid at this time.

Section 362(d)(2) was added to the Bankruptcy Code to address a dramatically different situation than what is at issue in this case. The section was:

intended to solve the problem of real property mortgage foreclosures of property where the bankruptcy petition is filed on the eve of foreclosure. The section is not intended to apply if the business of the debtor is managing or leasing real property, such as a hotel operation, even though the debtor has no equity if the property is necessary to an effective reorganization of the debtor.

See 124 Cong. Rec. H11047, H11092-93 (1978); 124 Cong. Rec. S 17403, S 17409 (1978) (emphasis added). This case is nothing like that simple case of an undersecured mortgage holder seeking to foreclose on its collateral in the paradigm § 362(d)(2) case. Here an independent Trustee has done an extensive investigation of years worth of transactions involving BONY, and

alleges serious breaches of duties by BONY, and massive avoidable transfers to BONY.² When that is combined with the lavish security BONY enjoys if the Trustee is ultimately unable to prove his allegations in the BONY Adversary Proceeding, there is simply no call for handing BONY the tactical advantage of permitting the repayment of its loans pending the outcome of the BONY Adversary Proceeding.

It is true that a § 362(d) motion to modify the stay is a summary proceeding, and that upon a secured creditor's showing of a "colorable" claim to a lien, the Court does not adjudicate counterclaims against the creditor and defenses to its claims. *In re Vitreous Steel Products Co.*, 911 F.2d 1223, 1234 (7th Cir. 1990). But that does not mean that the Court must blind itself to the context in which the Motion arises. *Vitreous Steel* was an appeal from the dismissal of an adversary proceeding, not a motion to modify the stay. The bankruptcy court in that case had dismissed the adversary proceeding based on findings it had made at a summary § 362 hearing, and that is what the *Vitreous Steel* court rejected. *Id.* at 1234 ("We hold that the determination of the § 362 motion is not a bar to the prosecution of the adversary complaint.")

The Seventh Circuit in *Vitreous Steel* did not hold that the Court must limit the considerations relevant to the exercise of its discretion under § 362(d) to whether the creditor has a colorable claim to a lien. It would make no sense if it had. First of all, it is self evident that the issue of equity/adequate protection is a relevant consideration in essentially any lift stay proceeding. Some form of that question is an element under both § 362(d)(1) and (2). *See In re Colonial Center*, 156 B.R. at 460 (noting that the determination of "adequate protection" under §

² The charges against BONY are serious and substantial, as evidenced by the fact that it is not just a Trustee who has sued BONY. BONY's relationship with Sentinel is the subject of at least one government investigation as well. While the existence of an investigation does not "prove" anything, it suggests that as much as BONY may have a "colorable" claim to a lien, the Trustee has "colorable" claims to defenses and counterclaims – and therefore to equity in even BONY's artificial "BNY Accrued Payoff Amount." The Court can and should take this into account in exercising its discretion under § 362(d).

362(d)(1) and “equity” under § 362(d)(2) are essentially identical when the secured creditor seeking relief from the stay holds the only lien). Moreover, cases following *Vitreous Steel* have made clear that while the Court does not determine counterclaims and defenses in a summary § 362 proceeding, that does not mean that they must be irrelevant to the exercise of discretion under § 362(d) either. In *Grella v. Salem Five Cent Savings Bank*, 42 F.3d 26, 34 (1st Cir. 1994), for example, the First Circuit adopted *Vitreous Steel’s* rationale and holding with respect to the summary nature of a lift stay proceeding. With respect to the purpose of § 362(d), it noted that

[i]n certain situations, such as when a creditor has a security interest in the debtor’s property and the value of the collateral is less than the amount of the debt, bankruptcy proceedings may only delay the inevitable result. There may be no reason to make the creditor wait for the distribution of the estate, and indeed, early release of the property may aid administration of the estate by allowing a quicker determination of the amount of an undersecured creditor’s claim.

Id. at 31 (citing *Vitreous Steel*). But the *Grella* court went on to emphasize that the inappropriateness of *adjudicating* defenses and counterclaims at a summary proceeding did not mean they should not be *considered*. It noted that the summary nature of the proceeding “*would not preclude the party seeking the continuance of the stay from presenting evidence on the existence of claims which the court may consider in exercising its discretion*. What is precluded is a determination of such collateral claims on the merits at the hearing.” *Id.* at 32-33 (citing S. Rep. No. 95-989, 95th Cong., 2d Sess. 55, reprinted in 1978 U.S. Code Cong. & Admin. News 5787, at 5841) (emphasis added).

Because BONY is so evidently adequately protected, and because the Debtor here so evidently has equity in the Restricted Accounts, the Court need not reach these issues. Nonetheless, if the Court does not simply deny the Motion based on BONY’s acknowledged excess of security, it should exercise its discretion in favor of allowing the stay to remain in

effect. No purpose is served by lifting it and the fact that BONY's liens and claims are in serious dispute counsels against doing so.

II. Even If the Court Finds the Statutory Grounds for Relief Met, It Should Limit the Relief Granted.

Even if the Court does feel the need to grant some sort of relief from the stay, under § 362(d), that relief does not have to amount to allowing BONY's disputed claim to be paid. A court can grant relief from the automatic stay by "terminating, annulling, *modifying*, or *conditioning such stay*." See 11 U.S.C. §362(d). In *Colonial Center*, for example, the Court noted that "[i]n the unusual circumstance where the secured creditor is clearly adequately protected, even though the elements of subsection 362(d)(2) have been demonstrated, a court may 'condition' the continuation of the bankruptcy stay upon certain actions by the debtor including actions designed to insure that such adequate protection remains in place." *Colonial Center*, 156 B.R. at 459 fn. 12; see also *In re Bivens*, 317 B.R. 755, 771 (Bankr. N.D. Ill. 2005) (Squires, J.) (conditioning continuation of stay in Chapter 13 case on debtor making payments required by payment plan and maintenance of insurance).

Here the Trustee submits that in light of BONY's security, if the Court is inclined to grant any relief, it should be limited to conditioning the stay in a way that will ensure that BONY retains an adequate level of protection by setting aside sufficient funds from BONY's alleged collateral to ensure the payment of BONY's claim at the conclusion of the BONY Adversary Proceeding if appropriate.

CONCLUSION

WHEREFORE, the Trustee respectfully requests that the Court enter an Order (i) denying the Motion and (ii) granting such other and further relief as this Court deems just.

Dated: Chicago, Illinois
August 25, 2008

Respectfully submitted,

**FREDERICK J. GREDE, chapter 11 trustee for
the estate of SENTINEL MANAGEMENT
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By: /s/ Vincent E. Lazar
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