No.

IN THE

Supreme Court of the United States

DOUGLAS F. MANN, as Chapter 7 Trustee of the estate of Engstrom, Inc.,
Petitioner,

v.

LSQ FUNDING GROUP, L.C.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Sections 544 and 548 of the Bankruptcy Code provide that a trustee may recover a transfer made by the debtor with the actual intent to defraud any creditor if the transfer involves "an interest of the debtor in property." Fraudulently transferred property recovered by the trustee is property of the debtor's estate and for the benefit of creditors generally. *See* 11 U.S.C. § 541(a)(3).

The question presented, on which courts of appeals are in conflict, is:

when a debtor defrauds a new creditor into making payment of an existing creditor's claims, whether the trustee seeking to avoid the fraudulent transfer also must demonstrate "diminution" or "harm" to the estate or creditors generally.

PARTIES TO THE PROCEEDINGS

Petitioner Douglas F. Mann, as chapter 7 trustee of the estate of Engstrom, Inc., was the plaintiff in the adversary proceeding in the bankruptcy court, and the appellant in the district court and court of appeals.

Respondent LSQ Funding Group, L.C. was the defendant in the adversary proceeding in the bankruptcy court, and the appellee in the district court and court of appeals.

RELATED PROCEEDINGS BELOW

This case arises from the following proceedings:

- *Mann v. LSQ Funding Grp., L.C. (In re Engstrom, Inc.)*, Adv. No. 20-2062-kmp / chapter 7 No. 20-22839-kmp, U.S. Bankruptcy Court for the Eastern District of Wisconsin. Decision and Order entered August 31, 2021.

- *Mann v. LSQ Funding Grp., L.C.*, No. 21-1070-bhl, U.S. District Court for the Eastern District of Wisconsin. Judgment entered July 15, 2022.

- *Mann v. LSQ Funding Grp., L.C.*, No. 22-2436, U.S. Court of Appeals for the Seventh Circuit. Judgment entered June 22, 2023 and rehearing *en banc* denied July 21, 2023.

Fraud claims asserted by Millennium against LSQ Funding Group, L.C. are pending in a state court action to which Petitioner is not a party. *See Canfield Funding Partners, LLC v. LSQ Funding Grp., L.C.*, No. 2022-CA-004435-O, Circuit Court of the Ninth Judicial Circuit, Orange County, Florida.

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Petitioner respectfully petitions for a writ of *certiorari* to review the judgment of the United States Court of Appeals for the Seventh Circuit.

OPINIONS AND ORDERS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit (the "Seventh Circuit") dated June 22, 2023 (App. 1a-13a) is reported at 71 F.4th 640. The Decision and Opinion of the United States District Court for the Eastern District of Wisconsin (the "District Court") dated July 15, 2022 (App. 14a-30a) is not reported in the national reporter, but is available at 2022 WL 2788437. The Decision and Order Granting Defendant's Motion for Summary Judgment of the United States Bankruptcy Court for the Eastern District of Wisconsin (the "Bankruptcy Court") dated August 31, 2021 (App. 31a-83a) is reported at 648 B.R. 617. The order of the Seventh Circuit denying rehearing *en banc* dated July 21, 2023 (App. 84a-85a) is not reported in the national reporter, but is available at 2023 WL 4684702.

JURISDICTION

The Seventh Circuit entered judgment on June 22, 2023 (App. 1a-13a), and denied a timely petition for rehearing *en banc* on July 21, 2023 (App. 84a-85a). The Bankruptcy Court had jurisdiction under 28 U.S.C. § 157(b), and the District Court had jurisdiction under 28 U.S.C. § 158(a)(1). This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

The appendix reproduces sections 541(a)(1)-(a)(3), 544, 548(a)(1)(A), and 548(c) of title 11 of the United States Code (the "Bankruptcy Code") and Wis. Stat. § 242.04(1)(a) and § 242.08(1). (App. 86a-91a.)

STATEMENT

A. Introduction

This case presents a fundamental question of federal bankruptcy law on which the courts of appeals are divided: do the Bankruptcy Code's fraudulent transfer provisions require that the trustee show "diminution" or "harm" to the estate or creditors generally, or may the trustee on behalf of the estate assert a valid claim if the debtor harms the new creditor by entering into a contract with the new creditor that provides for payment to satisfy the claims of an existing creditor?

When a debtor asks one creditor to make payment directly to a pre-existing creditor, the transferred funds may not pass through the debtor.

One creditor is repaid by another, resulting in a different creditor to whom the debtor owes payment.

Before the enactment of the Bankruptcy Code, this Court established a judicial principal that payment from one creditor to another is not avoidable as a *preferential* transfer because other non-participating creditors are not made worse off. However, this Court never has ruled that the "diminution doctrine" should apply when a trustee seeks to avoid a transfer made to an existing creditor with contract proceeds fraudulently obtained by the debtor.

The courts of appeals are divided on this question. Below, the Seventh Circuit sided with the Eleventh Circuit and other lower courts that adopted a diminution test for fraud. The rule adopted by these courts is unsound and unsupported by the text of the statute. Two other courts of appeals, the Second Circuit and the Fourth Circuit, have ruled that harm to the estate or to creditors generally is not a statutory element of fraudulent transfers when actual intent to hinder, delay or defraud is alleged. By their terms, the statutes only require the trustee to allege actual intent to harm a creditor—not some generalized harm to all creditors. *See supra* Section I-A. That makes sense: the focus of the statute is (and always has been) to punish wrongful conduct. The Seventh Circuit decision exempts an entire class of fraudulent transactions merely because one fraud victim is paid directly by a newly duped creditor. It is critical that this Court resolve the circuit split and dispense with the Seventh Circuit's "earmarked fraud" exemption.

As this Court has recognized, "[t]he Bankruptcy Code standardizes an expansive (and sometimes unruly) area of law" that requires courts to "interpret the Code clearly and predictably." *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 649 (2012). Engrafting the "diminution doctrine," historically applicable only to preference actions, onto the fraudulent transfer statutes is neither clear nor predictable. Punishing fraudulent transfers has been central to our uniform bankruptcy laws since this country's founding, without any historical exemption for fraudulent transfers that swap creditors.

B. Statutory Background

The Bankruptcy Code contains an intricate set of provisions governing fraudulent transfers and the recovery of fraudulent transfers for the benefit of the estate generally. 11 U.S.C. §§ 541, 544, 548 & 550. These provisions include the incorporation of state law creditors' rights statutes that preempt any individual creditor's right to sue and recover for itself. *Id.* at § 544. Causes of action to recover fraudulently transferred property are property of the debtor's estate, as well as any property or the value of property recovered. *Id.* at § 541(a)(3). After payment of administrative and priority claims, recoveries from fraudulently transferred property are distributed to unsecured creditors on a ratable basis. *Id.* at § 726.

Fundamentally, the Bankruptcy Code is concerned with wrongful transfers by the debtor of its property. If the debtor has actual intent to hinder, delay or defraud any creditor, and carries out that fraud with funds fraudulently obtained from a new creditor and used to satisfy the claims of an existing creditor, the trustee has the right to sue the initial transferee and any immediate and mediate transferees. *Id.* at § 550(a).

The relevant phrase, applicable both to sections 544 and 548, is the transfer of "an interest of the debtor in property." *Id.* at §§ 544, 548. If the property does not belong to the debtor, or the debtor does not have any interest in the property that may belong to someone else, then the trustee cannot use these statutes as recovery tools for the benefit of the estate.

The applicable text requires only that a single creditor be the intended victim of the debtor's actual intent to defraud. State law, here the Wisconsin fraudulent transfer act, Wis. Stat. § 242.08(1), and made applicable by section 544, refers to a transfer made with intent to hinder, delay or defraud "any creditor." Section 548 refers to a transfer made with actual intent to hinder, delay or defraud "any entity." 11 U.S.C. § 548. As is often the case when a Ponzi perpetrator is found out, arrangement is made to silence the old creditor with funds obtained from a new victim. No other creditor (other than the defrauded creditor) is worse off because the harmed creditor's claim is offset by the repaid creditor's claim.

When the debtor induces one creditor to directly repay another creditor on behalf of the debtor outside of the fraud context, the funds are characterized as having been "earmarked." Earmarked funds cannot be used for general purposes and can be used only to repay the designated creditor. As such, prior to enactment of the Bankruptcy Code, this Court had established a judicial principle that exempted these transactions from attack as a voidable preference. The reasoning, based on the purpose of the preference statute, was that there is no "diminution" to the estate such that other creditors were made worse off.

Whether the earmarking doctrine with respect to preferences has survived enactment of the 1978 Bankruptcy Code is debatable. The Bankruptcy Code did not expressly incorporate the earmarking or diminution doctrine as a defense to a preference claim. However, many courts have held that the historical diminution doctrine survived enactment of the preference provisions of the Bankruptcy Code. Whether valid or not, more recently courts have begun to expand the diminution doctrine beyond its historical roots. These courts declare that, similar to pre-Bankruptcy Code practice, an earmarked transfer from one creditor to another could not have been used for any other purpose and, therefore, there was no "interest of the debtor in property." Many courts of appeals, including the Seventh Circuit, declared this earmarking or diminution requirement to be an "exception" to the statute. *Matter of Smith*, 966 F.2d 1527, 1533 & 1534, n. 9 (7th Cir. 1992); *In re ESA Env't Specialists, Inc.*, 709 F.3d 388, 394 (4th Cir.

2013) ("earmarking defense in bankruptcy is a judicially created exception"); *In re Entringer Bakeries, Inc.*, 548 F. 3d 344, 347 n. 3 (5th Cir. 2008) ("earmarking doctrine is a judicially created, equitable exception"); *In re Lee*, 530 F.3d 458, 467-68 (6th Cir. 2008) ("judicially-crafted 'earmarking doctrine'. . . is a judicially created defense); *In re Kemp Pac. Fisheries, Inc.*, 16 F.3d 313, 316 n.2 (9th Cir. 1994) ("earmarking doctrine is a creature of equity").

Below, the Seventh Circuit went further and extended the diminution doctrine to fraudulent transfers. Its rationale was simple: the phrase "interest of the debtor in property" has been deemed in other contexts to include a requirement that the estate be diminished if such property were transferred. If the estate is not diminished, according to the Seventh Circuit, then the debtor could not have had "any interest in property" fraudulently transferred. As discussed below, the Seventh Circuit's decision ignored the direct fraud and injury to one creditor by netting against that harm the repayment of the debtor's obligations to a pre-existing creditor.

C. Factual Background

Petitioner, the chapter 7 trustee of Engstrom, Inc. ("Petitioner" or "Trustee"), sued Respondent, LSQ Funding Group, L.C. ("Respondent" or "LSQ") in the Bankruptcy Court to avoid, as a fraudulent and preferential transaction, payment to LSQ that enabled Engstrom, Inc. ("Debtor") to repurchase phony receivables from LSQ and resell those phony receivables to a second creditor, Canfield Funding LLC d/b/a Millennium Funding ("Millennium").

Debtor had induced LSQ to enter into a standard commercial transaction to purchase and factor accounts receivable. Over time, Debtor received more than $10 million of purchase price proceeds under that transaction. The accounts, however, were fake. LSQ eventually learned about the fraud and arrangements were made by Debtor, allegedly with the knowing participation of LSQ, to dupe a second creditor, Millennium, so that LSQ could get paid and leave Millennium holding the bag.

The scheme involved multiple component transactions, whereby (i) Debtor solicited Millennium to buy phony accounts for $10.3 million, (ii) Millennium conditioned its agreement to pay for the accounts upon LSQ reselling the accounts to Debtor and terminating its UCC-1 financing statement, (iii) LSQ agreed to resell the accounts in exchange for payment of $10.3 million, (iv) upon repurchase of the accounts from LSQ, Debtor agreed to concurrently sell the accounts to Millennium for $10.3 million, and (v) substantially contemporaneously, at Debtor's direction and based on LSQ's wire instructions, Millennium wired $10.3 million directly to LSQ, LSQ resold the accounts to Debtor, and Debtor sold the accounts to Millennium for $10.3 million.

The Bankruptcy Court granted summary judgment in favor of LSQ on multiple causes of action asserted by Petitioner, based upon its application of a non-statutory earmarking doctrine. (App. 31a-83a.) On appeal, the District Court entered its Decision and

Order affirming the grant of summary judgment on the grounds that the earmarking doctrine applies to fraudulent transfer actions no differently than it applies to preference actions, and that the earmarking doctrine did not permit consideration of alleged inequitable conduct by LSQ. (App. 14a-30a.) The Seventh Circuit entered judgment on June 22, 2023 (App. 1a-13a.), and denied a timely petition for rehearing *en banc* on July 21, 2023 (App. 84a-85a).

REASONS FOR GRANTING THE PETITION

I. THERE IS A FUNDAMENTAL CIRCUIT COURT SPLIT ON THE QUESTION

There is a clear conflict among the courts of appeals on the question presented—a question that could hardly be more fundamental to bankruptcy and equality of distributions among creditors. In the Second and Fourth Circuits, if the trustee can establish the debtor's actual intent to hinder, delay or defraud any creditor, there is no requirement to also show "diminution" or "harm" to the estate. *HBE Leasing Corp. v. Frank*, 48 F.3d 623 (2d Cir. 1995); *Tavenner v. Smoot*, 257 F.3d 401, 407-8 (4th Cir. 2001). In the Seventh and Eleventh Circuits, if one defrauded creditor is fraudulently induced to repay another creditor, and the debtor's estate is no worse off in the aggregate, then the transfer is not avoidable in spite of the debtor's actual fraud. App. 1a-13a; *In re Chase & Sanborn Corp.*, 813 F.2d 1177 (11th Cir. 1987). The Seventh Circuit decision failed to cite to this split and chose to follow the Eleventh Circuit approach that searched for "diminution" or "harm" despite a showing of actual intent to defraud. (App. 1a-13a.)

A. Second and Fourth Circuits

In a pre-Bankruptcy Code case, this Court established the rule that a transfer may be fraudulent in law even if the assets remain available to satisfy the claims of creditors in full. *Shapiro v. Wilgus*, 287 U.S. 348 (1932) (Cardozo, J.). In *Shapiro*, the individual debtor transferred substantially all of his assets and liabilities into a newly formed corporation, in order to enable the corporation to take advantage of local receivership proceedings. *Id.* at 352. The grantee corporation agreed to assume and be liable for all of the grantor's liabilities. *Id.* The Third Circuit found the transaction to be fair and lawful. *Id.* at 354. This Court reversed, noting "[a] conveyance is illegal if made with an intent to defraud the creditors of the grantor, but equally it is illegal if made with an intent to hinder and delay them. Many an embarrassed debtor holds the genuine belief that, if suits can be staved off for a season, he will weather a financial storm, and pay his debts in full. The belief even though well founded, does not clothe him with a privilege to build up obstructions that will hold his creditors at bay." *Id.* at 354 (internal citation omitted), citing the Statute of Elizabeth. Official Comment 8 to the Uniform Voidable Transactions Act (formerly known as the Uniform Fraudulent Transfer Act), cites *Shapiro* for the proposition that "[d]iminution of the assets available to the debtor's creditors is not necessarily required to 'hinder, delay, or defraud' creditors." *See* National Conference of

Commissioners on Uniform State Laws, *Uniform Voidable Transactions Act (Formerly Uniform Fraudulent Transfer Act) (as amended in 2014)*, at comment 8. As discussed below, the rule in *Shapiro* has been faithfully carried forward by the Second and Fourth Circuits.

Both the Second and Fourth Circuits have held that transfers made with actual intent to hinder, delay or defraud a creditor are avoidable without the need to establish economic harm to the estate. In *Tavenner*, the chapter 7 trustee asserted a fraudulent transfer claim against the debtor under section 548(a)(1) alleging actual intent to hinder, delay or defraud. *Tavenner*, 257 F.3d at 407-8. The debtor, Smoot, had received funds from a settlement of a workplace injury and then moved those funds into various bank accounts while being pursued by creditors. The Fourth Circuit noted that Smoot, if he had not moved the funds, could have exempted the funds from his bankruptcy estate. *Id.* at 406. Smoot, in turn, claimed that he could not be liable for a fraudulent transfer made with actual intent to hinder, delay or defraud because none of his creditors could have enjoyed the exempt proceeds of his settlement. *Id.* at 407. The Fourth Circuit flatly disagreed, noting that the transactions can be characterized as fraudulent (under section 548(a)(1)) "so long as the debtor had the requisite fraudulent intent." *Id.*

In other words, the statute seeks to punish actual fraudulent intent without regard to the economic consequences of the fraud. As the Fourth

Circuit held, "[n]othing in § 548 indicates that a trustee must establish that a fraudulent conveyance actually harmed a creditor… Section 548 properly focuses on the intent of the debtor, for if a debtor enters into a transaction with the express purpose of defrauding his creditors, his behavior should not be excused simply because, despite the debtor's best efforts, the transaction failed to harm any creditor" *Id.* at 407; *see also In re Feynman*, 77 F.2d 320, 322 (2d Cir. 1935) ("The law forbids all efforts to put property beyond the reach of creditors, no matter what its value; so long as courts are tolerant of such conduct, men will engage in it and the purposes of the bankruptcy act will be balked"); *Empire Lighting Fixture Co. v. Practical Lighting Fixture Co.*, 20 F.2d 295, 297 (2d Cir. 1927) ("An intent to delay and hinder creditors is as much within the statute as an intent to defraud them, and, if it exist, it is of no moment that the grantor be solvent"). There is no test under the statute that requires the measurement of economic harm to the estate, whether characterized as "diminution" or "depletion" or "harm" to the estate or its creditors. If the debtor acts with the requisite intent, the transfer is unwound and recoveries belong to the estate to be distributed in accordance with the Bankruptcy Code.

The rule is the same in the Second Circuit with respect to fraudulent transfer claims asserted under New York law. The Bankruptcy Code incorporates such claims by reference under section 544(b)(1). 11 U.S.C. § 544(b)(1). In *HBE Leasing Corp. v. Frank*, 48 F.3d at 639, the Second Circuit squarely held that "a transfer made with actual intent to hinder, delay, or defraud present or future creditors is fraudulent as to such creditors, regardless of whether the debtor receives fair consideration for its property." *HBE Leasing* addressed fraudulent transfer claims asserted against attorneys who were paid by an insolvent party defending RICO claims, citing New York Uniform Fraudulent Conveyance Act, N.Y. Debt. & Cred. Law § 276 (McKinney 1990). The attorneys had provided fair consideration to the transferors in exchange for the payments, but the Second Circuit reversed the District Court for its failure to consider that a transfer made with actual intent to defraud is fraudulent regardless of the consideration given. In other words, the fraudulent transfer statute does not include an economic impact test with respect to claims of actual intent to defraud. *HBE Leasing*, 48 F.3d at 639-40, citing *United States v. McCombs*, 30 F.3d 310, 327-28 (2d Cir. 1994) ("where actual intent to defraud creditors is proven, the conveyance will be set aside [under DCL § 276] regardless of the adequacy of consideration given"). *See also In re Sharp Int'l Corp.*, 403 F.3d 43, 56 (2d Cir. 2005) (same), citing *McCombs*; 30 F.3d 310, *cf. In re Picard, Tr. for Liquidation of Bernard L. Madoff Inv. Sec. LLC*, 917 F.3d 85, 97-98 (2d Cir. 2019) ("A general purpose of 'the Bankruptcy Code's avoidance provisions, including 11 U.S.C. § 548, [is] protect[ing] a debtor's estate from depletion to the prejudice of the unsecured creditor").

B. Seventh and Eleventh Circuits

Below, the Seventh Circuit failed to cite the rule from the Second and Fourth Circuits and chose to follow the Eleventh Circuit's approach. (App. 1a-13a, citing *In re Chase & Sanborn Corp.*, 813 F.2d at 1181 (interpreting "property of the debtor" to require diminution of the estate under both sections 547 and 548)). *Compare Matter of Smith*, 966 F.2d at 1536-37 & n. 13 ("[t]he view that 'an interest of the debtor in property' turns on a diminution of the debtor's 'estate' would seem to conflict with the Supreme Court's admonition that the property issue is simply a matter of state law"). *Chase and Sanborn* involved a "bewildering" series of related financial transaction that, at bottom, involved funds that flowed from a third party to the debtor and then from the debtor to various immediate and mediate transferees. *In re Chase & Sanborn Corp.*, 813 F.2d at 1179-81. The Eleventh Circuit affirmed the dismissal of the trustee's fraudulent conveyance claims under section 548, concluding that the funds transferred were not the debtor's property. The Eleventh Circuit reached this conclusion based on the facts that the funds, while passing through the debtor's corporate bank account, were obtained as a personal loan made in favor of the debtor's president and that the loan proceeds were at all times controlled by him. *Id.* at 1182. The Eleventh Circuit declared (without reference to any case law) that "the purpose of avoidance of both types of [preferential and fraudulent] transfers is to prevent a debtor from diminishing, to the detriment of some or all creditors, funds that are generally available for distribution to creditors." *Id.* at 1181. Similarly, in dicta the Eleventh Circuit announced without supporting case law that "[f]raudulent transfers are avoidable because they diminish the assets of the debtor to the detriment of all creditors." *Id. Chase and Sanborn* is the only circuit court authority cited by the Seventh Circuit for its rule that fraudulent transfers under the Bankruptcy Code must "diminish the Debtor's estate." (App. 9a-10a.)[1]

The law of the Seventh and Eleventh Circuits is thus squarely at odds with that of the Second and Fourth Circuits on an important and recurring question of fundamental bankruptcy law — whether recovery of transfers made with intent to hinder, delay or defraud requires a non-statutory showing of diminution or harm.[2] The Court should grant review

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[1] The Seventh Circuit added that its decision "aligns comfortably with those of our sister circuits, several of which have held or suggested that, even in the Ponzi scheme context, outright fraud alone cannot bring a transaction within the avoiding powers of the Bankruptcy Code." (App. 11a-12a.) However, each of the other circuit court cases were decided on the grounds that no "transfer" had occurred. Similarly, the Seventh Circuit found support in this Court's decision in *Begier v I.R.S.*, 496 U.S. 53 (1990). The property in question in *Begier* was held in trust when it was transferred such that it was not property of the debtor by reason of section 541(d) of the Bankruptcy Code. Section 541 says nothing about excluding property that is contractually required to be used for payment to a specified creditor. 11 U.S.C. § 541. Accordingly, *Begier* stands for the opposite proposition that earmarked property is property of the estate because it is not statutorily excluded under section 541.

[2] By contrast, both the Seventh and Eleventh Circuits have determined that no "diminution" criterion exists under section 727 for purposes of whether a debtor, who acted with fraudulent intent to transfer property, will be denied a discharge. *See In re Smiley*, 864 F.2d 562, 569 (7th Cir. 1989) (section 727(a)(2) denial of discharge for fraudulent transfers "does not provide that the creditors must have, in fact, been hindered, delayed or defrauded"); *In re Davis*, 911 F.2d 560, 562 (11th Cir. 1990)

to restore uniformity to federal bankruptcy law on this question of exceptional importance.

II. THE SEVENTH CIRCUIT'S DECISION IS INCORRECT

A. The Seventh Circuit Rule Is Judicial Gloss Not Found In The Text of The Bankruptcy Code

The "diminution" principle adopted by the Seventh Circuit cannot be squared with the text, structure, policy and history of the Bankruptcy Code's fraudulent transfer laws. This Court has instructed lower courts to interpret the Bankruptcy Code by starting with the language of the statute. *See Lamar, Archer & Cofrin, LLP v. Appling*, 138 S. Ct. 1752, 1759 (2018) ("Our interpretation of the Bankruptcy Code starts 'where all such inquiries must begin: with the language of the statute itself.'"). The relevant phrases in the Bankruptcy Code fraudulent transfer sections are the same. Section 544(b)(1) of the Bankruptcy Code provides that "the trustee may avoid any transfer of an interest of the debtor in property. . . that is voidable under applicable law by a creditor holding an unsecured claim. . . ." 11 U.S.C. § 544(b)(1). In this case, the "applicable law" referred to in section 544(b)(1) is Wisconsin's Uniform Fraudulent Transfer Act. Wis. Stat. § 242. The Trustee stood in the shoes of the harmed creditor, Millennium, under section 544 and Wisconsin fraudulent transfer law. The relevant language of

(debtor denied discharge under section 727(a)(2) based on fraudulently transferred property despite the subsequent reconveyance of the property and no economic harm to creditors).

section 548(a)(1)(A) provides that "[t]he trustee may avoid any transfer. . . of an interest of the debtor in property. . . that was made. . . within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily. . . made such transfer. . . with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, . . . indebted. . . ." 11 U.S.C. § 548(a)(1)(A). The phrase "an interest of the debtor in property" refers to property rights under state law. *Barnhill v. Johnson*, 503 US 393, 396-98 (1992), citing *Butner v. United States*, 440 U.S. 48, 54-55 (1979) ("property interests are created and defined by state law. . . [u]nless some federal interest requires a different result").

But for the agreed-upon sale between Debtor and Millennium, Debtor would not have received the $10.3 million in sale proceeds to repurchase its accounts from LSQ, necessarily making the $10.3 million transfer one of an interest of the debtor in property. Debtor sold its accounts receivable to Millennium for $10.3 million. Debtor thereby acquired an interest in the $10.3 million. It then used that $10.3 million, in which it then possessed an interest, to repurchase accounts then owned by LSQ. Thus, Debtor transferred an interest in its property to LSQ. *See McGoldrick v. Juice Farms, Inc. (In re Ludford Fruit Prods., Inc.)*, 99 B.R. 18, 21 (Bankr. C.D. Cal. 1989) ("Common sense is stretched to the breaking point when a court finds that funds loaned to a debtor, even for the specified purpose of paying an existing creditor, do not become property of the debtor.").

The Seventh Circuit referenced the applicable phrase as being "an interest of the debtor in property." (App. 5a-8a.) Instead of parsing the meaning of each word of that phrase, however, the Seventh Circuit introduced a test for fraudulent transfers under sections 544 and 548 never before applied by that circuit or this Court: "whether the transfer diminishes the property of the estate" with a goal of determining "whether the transfer took something from the pool of assets that would otherwise have gone to creditors." (App. 6a.)

There is no statutory requirement for "diminution" in sections 544 and 548 of the Bankruptcy Code. The language in sections 544 and 548 is plain and, as such, "the inquiry should end." *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989). The Seventh Circuit declared this diminution test despite its previous statement in *Matter of Smith*, 966 F.2d at 1536, n. 13, that a diminished estate element for preferential transfer "would seem to conflict with section 547's specific elements." Far from historical preference law left undisturbed by *Matter of Smith*, the Seventh Circuit decision below invokes a new "diminished estate" element as judicial gloss that goes beyond the fraudulent transfer statutes. *Law v. Siegel*, 571 U.S. 415, 421 (2014) ("'whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of' the Bankruptcy Code"); *In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004) ("Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text").[3]

The Seventh Circuit concluded that no "interest of the debtor in property" was transferred because the fraud against one creditor (Millennium) was used to repay the claims of another creditor (LSQ) such that the net effect of multiple steps of a fraudulent scheme was the substitution of one creditor for another. (App. 8a.) Notwithstanding the actual intent to defraud and the undisputed harm to the defrauded creditor, the Seventh Circuit searched for additional harm to other creditors. As noted above,

[3] Other decisions from the courts of appeals have inconsistent references to diminution or similar requirements in the Bankruptcy Code. For example, *see Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995) (equivalent value is not relevant if fraud in fact is shown) cited by *In re Spatz*, 222 B.R. 157, 169-70, 173 (N.D. Ill. 1998) ("if the bankruptcy court finds that [the debtor] made the transfer with fraudulent intent, and [the transferee] cannot establish a defense under § 9, [transferee] 'must return the entire payment he received"); compare *Deel Rent-A-Car, Inc. v. Levine*, 721 F.2d. 750, 755-58 (11th Cir. 1983) (there is no "diminution of estate requirement" for purposes of a debtor's claimed exemption under section 522(h)(1) when a transfer is "avoidable by the trustee under section 544 [or] 548." 11 U.S.C. § 522(h)(1)). In addition, the Ninth Circuit has rejected a non-statutory "diminution of estate" element for avoidance of post-petition transfers under section 549, while recognizing that other courts have found a non-statutory diminution of estate element for avoidable transfers under sections 547 and 548. *See In re Straightline Invs., Inc.*, 525 F.3d 870, 878-79 (9th Cir. 2008); *cf. In re Marshall*, 550 F.3d 1251, 1257 at n.5 (10th Cir. 2008) (questioning but not deciding the continued viability of a diminution requirement for preferences); *In re Bohlen Enters., Ltd.*, 859 F.2d 561, 565-66 (8th Cir. 1988) (questioning the statutory basis for a diminution requirement for preferences).

the text of the fraudulent transfer statutes require only a showing of intent to harm a single creditor. Moreover, section 544(b) unambiguously "gives the trustee the rights of actual unsecured creditors under applicable law to avoid transfers." S. Rep. 95-989, 95th Cong. (1978), *citing Moore v. Bay*, 284 U.S. 4 (1931). Said another way, there is no case supporting a "diminution" exception under the applicable Wisconsin fraudulent transfer act; therefore, there can be no exception for "diminution" under section 544(b). *In re Equip. Acquisition Res., Inc.*, 742 F.3d 743, 747-48 (7th Cir. 2014) ("§544(b) is unambiguous: the trustee may only recover transfers that are 'voidable under applicable law by a creditor holding an unsecured claim'"); *see generally In re Moses*, 256 B.R. 641, 645 (B.A.P. 10th Cir. 2000).

Further, invoking a non-statutory doctrine, one that allows a creditor to knowingly receive and retain a transfer made by the debtor with actual fraudulent intent, renders the "good faith" requirements of section 548(c) (and Wis. Stat. § 242.08(1)) a practical nullity and largely superfluous. 11 U.S.C. § 548(c); Wis. Stat. § 242.08(1); *City of Chicago, Ill. v. Fulton*, 141 S. Ct. 585, 591 (2021) ("canon against surplusage is strongest when an interpretation would render superfluous another part of the same statutory scheme"); *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 375 (1988). Challenges to fraudulent transfers on the one hand and safe harbors or good faith defenses on the other are "two sides of the same coin." *FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*, 830 F.3d 690, 694 (7th Cir. 2016), *aff'd*, 138 S. Ct. 883 (2018). By reason of the

Seventh Circuit decision, LSQ escaped any requirement to show its good faith.

B. The Diminution Doctrine Should Be Confined To Preference Law And Not Extended To Fraudulent Transfer Law

The "diminution" doctrine had evolved prior to enactment of the Bankruptcy Code of 1978 and had been limited to preference law. The historical purposes of fraudulent transfer statutes and preference statutes are distinct from one another. Affixing a judge-made exception for preferences onto fraudulent transfer statutes not only violates the Bankruptcy Code, it also is incompatible with the historical application of the statutes.

"Every American bankruptcy law has incorporated a fraudulent transfer provision." *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 541 (1994). Fraudulent transfer law punishes transfers made with the actual intent to hinder, delay or defraud. *Husky Int'l Elecs., Inc. v. Ritz*, 578 U.S. 356, 361 (2016). This country borrowed its fraudulent transfer laws, by far the older creditor recovery tool, from the Statute of 13 Elizabeth from 1571. *Id.* at 360-61. The first cases involved actual intentional fraud, but the law evolved to the point where "badges of fraud" were used as proxies for other circumstances where transactions were unwound for the benefit of creditors generally. Douglas G. Baird, *The Unwritten Law of Corporate Reorganizations*, at p. 11 (2022), citing *Twyne's Case*, 76 Eng. Rep. 809 (K.B. 1601). The purpose of these laws, statutes and jurisprudence was to discourage fraudulent efforts and to give courts the tools to right the wrongs from actual fraud. Wrongdoers, debtors and creditors who assist them, are held to account and, in the event of bankruptcy, that accounting runs in favor of the estate and all creditors generally. *Moore*, 284 U.S. at 4-5. *See also* 11 U.S.C. § 541(a)(3).

This Court has reviewed transfers alleged to have been both fraudulent and preferential. *Dean v. Davis*, 242 U.S. 438 (1917). The law at the time, the Bankruptcy Act as amended as of 1903, avoided transfers either (i) made "with the intent and purpose on [the debtor's] part to hinder, delay or defraud his creditors, or any of them" or (ii) "which the person receiving the same has reason to believe was intended to give a preference." *Id.* at 441-42, citing the Bankruptcy Act (as amended Feb. 5, 1903, 32 Stat. at L. 800, chap. 487, and Act June 25, 1910, 36 Stat. 842, c. 412, § 11, Comp. Stat. 1913, § 9644) § 60(b) and § 67(e). Jones, the debtor, defrauded his bank with forged notes. He approached his brother-in-law, Dean, who arranged for a secured loan to Jones, the proceeds of which were used to "take up" the bank's forged notes. *Dean*, 242 U.S. at 442. Dean's secured notes were, by design, immediately in default enabling Dean to take possession of all of Jones' assets. Jones' unsecured creditors challenged Dean's mortgage and within days filed an involuntary bankruptcy petition against Jones. Jones' assets were monetized, including those in Dean's possession. The Fourth Circuit held Dean's mortgages were void as fraudulent and preferential transfers. *Id.* at 443.

This Court held that Dean did not receive a preference (the bank did) because the mortgage was given in exchange for a substantially contemporary advance. *Id.* However, the fraudulent transfer statute is "much broader" and covers any transfer made with fraudulent intent, "except as to purchasers in good faith and for a present fair consideration." *Id.* at 444. The two statutes had different designs in 1903 just as they do today. This Court concluded that the same transaction may be both fraudulent and preferential, or only one or the other. *Id.* at 444, citing *Van Iderstine v. Nat'l Discount Co.*, 227 U.S. 575, 582 (1913) ("The statute recognizes the difference between the intent to defraud and the intent to prefer . . . One is inherently and always vicious; the other innocent and valid, except when made in violation of the express provisions of a statute"). Jones had acted with the requisite fraudulent intent and Dean "who, knowing the facts, cooperated in the bankrupt's fraudulent purpose, lacked the saving good faith." *Dean*, 242 U.S. at 445.

Diminution, as a judicial gloss, historically pertained only to preferences. *New York Cnty. Nat'l Bank v. Massey*, 192 U.S. 138 (1904). After noting that the preference statutes "are not to be narrowly construed so as to defeat their purpose, no more can they be enlarged by judicial construction to include transactions not within the scope and purpose of the act," this Court announced the "diminution doctrine" as follows: "This section, 1(25) [defining "transfer"], read with §§ 57(g) and 60(a) [of the Bankruptcy Act], requires the surrender of preferences having the effect of transfers of property 'as payment, pledge, mortgage, gift, or security which operate to diminish the estate of the bankrupt and prefer one creditor over another.'" *Id.* at 146. *See also Cont'l & Com. Trust & Sav. Bank v. Chicago Title & Trust Co.*, 229 U.S. 435, 443 (1913), citing *Massey,* 192 U.S. at 147 and *Nat'l Bank of Newport v. Nat'l Herkimer Cnty. Bank*, 225 U.S. 178, 184 (1912); *In re Moses*, 256 B.R. at 645 (citing *National Herkimer County Bank* as a source for the earmarking doctrine for preferences).

These prior statutes, constructs and principles, all of which pertained exclusively to preference statutes then in effect, were overhauled and restated as section 547 of the Bankruptcy Code. 11 U.S.C. § 547; *Union Bank v. Wolas*, 502 U.S. 151, 160 (1991) ("the fact that Congress carefully reexamined and entirely rewrote the preference provision in 1978 supports the conclusion that the text of § 547(c)(2) as enacted reflects the deliberate choice of Congress."). At no time prior to enactment of the Bankruptcy Code had this Court endorsed application of the diminution doctrine to fraudulent transfers. Based upon the foregoing and the different statutory purposes underlying fraudulent transfers and preferences, the diminution doctrine should have been confined to preference law.

C. The Recovery Of The Fraudulently Transferred Funds Would Benefit The Estate And Its Creditors, Not Merely Millennium

A natural consideration of a diminution requirement has some plausibility. After all, if property transferred did not result in some depletion, then how could there have been any "transfer" of "property" in the first place? The answer is found in an extremely common fact pattern, where one creditor provides funds to the debtor to repay another creditor. Before and after the transactions, the estate is neutral and only the identity of creditors has changed. But in the context of fraudulent transfer law, the payment by one creditor to another is in furtherance of a fraudulent scheme. It is of no moment that one creditor take the loss for another — the only relevant statutory inquiry is whether the debtor acted with actual fraudulent intent in causing the transfer of the credit extended.

Fundamentally, when a fraudulent transfer is recovered by the estate, the recoveries benefit the estate generally. The Seventh Circuit's emphasis on "equality of distribution" makes the mistake of assuming that the recovery from LSQ would be paid to Millennium. (App. 11a.) That is not how the Bankruptcy Code works. Avoidance actions and related recoveries are property of the estate. 11 U.S.C. § 541(a)(3); *In re Simply Essentials, LLC*, 78 F.4th 1006 (8th Cir. 2023). Property recovered by the estate is distributed in accordance with the priorities of the Bankruptcy Code. That means that all creditors, including those who were not involved in the initial fraud, share proportionately with all distributions made to unsecured creditors. *Moore v. Bay*, 284 U.S. at 4-5.

The Seventh Circuit's decision involves a question of exceptional importance insofar as it announces a new rule applicable to all fraudulent transfer claims in all future bankruptcy cases in that circuit, including claims arising under federal law, section 548 (App. 1a-13a.) and claims arising under state fraudulent transfer law incorporated by reference into section 544. This case is not merely a two-party dispute between Millennium and LSQ; the Trustee is not a party to a separate state court action between Millennium and LSQ. Trustee represents a bankruptcy estate that has other unpaid creditors who cannot recover their losses in that action. *In re Leonard*, 125 F.3d 543, 544-45 (7th Cir. 1997) (recoveries under section 544(b) are divided among all unsecured creditors "not just the creditor who could have reached the asset outside bankruptcy"), citing *Moore v. Bay*, 284 U.S. at 4-5. By conflating these multiple transactions among the Debtor, LSQ and Millennium into a two-party dispute and by looking for actual harm to other creditors, the Seventh Circuit has disrupted the very principle of equality among creditors. *See Cunningham v. Brown*, 265 U.S. 1, 13 (1924) (Charles Ponzi and his scheme created "circumstances of which call strongly for the principle that equality is equity, and this is the spirit of the bankrupt law").

CONCLUSION

For the foregoing reasons, this Court should grant the petition for a writ of *certiorari*.

October 16, 2023 Respectfully submitted,

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APPENDIX

TABLE OF APPENDICES

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT, FILED JUNE 22, 2023

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 22-2436

DOUGLAS F. MANN,

Appellant,

v.

LSQ FUNDING GROUP, L.C.,

Appellee.

Appeal from the United States District Court for the Eastern District of Wisconsin.
No. 21-cv-1070-bhl — **Brett H. Ludwig**, *Judge.*

Argued February 16, 2023 — Decided June 22, 2023

Before RIPPLE, SCUDDER, and ST. EVE, *Circuit Judges.*

ST. EVE, *Circuit Judge*. Weeks before Engstrom, Inc. declared bankruptcy, its CEO orchestrated a payoff agreement between one of its existing creditors, LSQ Funding Group, L.C., and a new lender, Millennium Funding. Pursuant to the agreement, Millennium paid Engstrom's debt to LSQ, replacing LSQ as Engstrom's creditor. In exchange, LSQ released the entirety of its interest in Engstrom's accounts, which immediately went to Millennium. At that point, any payment on those accounts would go to Millennium instead of to LSQ.

Once Engstrom filed for bankruptcy, the Trustee of its estate sued LSQ in an attempt to avoid the payoff. As part of the suit, the Trustee alleges that the accounts Millennium purchased were worthless and that LSQ conspired with Engstrom to leave Millennium with the phony accounts when Engstrom's business fell apart. As the Trustee sees it, Engstrom used the new financing Millennium provided to pay off LSQ, keep them quiet about the fake accounts, and keep its Ponzi scheme running just a little while longer.

Accordingly, the Trustee argued that the payoff agreement was avoidable as both a preferential and a fraudulent transfer. The bankruptcy court dismissed the suit, holding that the payoff agreement was not avoidable because it did not qualify as a transfer of "an interest of the debtor in property." 11 U.S.C. §§ 547, 548. The district court held the same. Because the transaction had no effect on Engstrom's bankruptcy estate, the Bankruptcy Code's avoidance provisions play no role here, and we affirm.

I. Background

A. Factual History

LSQ Funding Group, L.C., provides invoice-factoring services to other businesses. That means it contracts with companies that need to collect on certain accounts, fronts the money for those accounts, acquires the legal rights to the accounts, and then collects on them for a fee. In June 2018, LSQ had an agreement to provide factoring services for Engstrom, Inc. (hereafter, "the Debtor"). According to the Trustee, that agreement was a sham, part of a larger fraud scheme run by the Debtor's CEO, Cheri Campion. Because this is an appeal from a grant of summary judgment, we must assume those allegations to be true to the extent they are supported by the record, but "we are not vouching for the objective truth of every fact that we must assume to be true for purposes of the appeal." *Freelain v. Village of Oak Park*, 888 F.3d 895, 898-99 (7th Cir. 2018).

The Trustee alleges that Campion ran a Ponzi scheme by entering into factoring agreements based on phony accounts. He claims that she fabricated invoices from fake companies as if they owed money to the Debtor, sold those invoices to companies like LSQ through factoring agreements, and then paid the invoices herself using money from other fraudulent agreements. According to the Trustee, this created the appearance that the Debtor was a flourishing business, even as it hurtled towards insolvency. But Millennium asserts that LSQ caught on to the fraud and terminated its agreement with the Debtor in January 2020. With the contract terminated, the Debtor owed LSQ roughly $10.3 million.

Of course, as is often the case in fraud schemes like these, the Debtor did not have $10.3 million. The Trustee believes that Campion's solution was to team up with LSQ to defraud a new company and use the proceeds to pay the $10.3 million debt. The Debtor chose Millennium Funding to take LSQ's place. Millennium would pay the $10.3 million to LSQ directly, and LSQ, in turn, agreed to release any rights it had in the Debtor's invoices, leaving them free for Millennium. But Millennium claims that its purchase was worthless because the Debtor had fabricated its accounts. And within three months of this transaction, the Debtor filed for bankruptcy.

B. Procedural History

The Trustee of the Debtor's estate brought this case, seeking to avoid the $10.3 million payment as a preferential transfer under § 547(b) or a fraudulent transfer under § 548(a)(1).[1]

The bankruptcy court entered summary judgment for LSQ based on the so-called "earmarking doctrine." This widely recognized doctrine exempts from § 547(b)'s avoidance power financial transactions like the payoff agreement here—where one creditor gives a debtor "earmarked" funds to pay off a specific debt in full, thereby assuming the original creditor's position.[2] Applying this doctrine, the bankruptcy court concluded

1. The Trustee subsequently added a claim that the transaction was avoidable as a state-law fraudulent transfer under 11 U.S.C. § 544(b)(1) and Wis. Stat. § 242.04(1).

2. We tread carefully in defining the doctrine, as neither the parties nor our sister circuits agree on whether this is an equitable exception to the Bankruptcy Code or an interpretation of the Code's plain language. *Compare In re Adbox, Inc.*, 488 F.3d 836, 842 (9th Cir. 2007) *with In re ESA Env't Specialists, Inc.*, 709 F.3d 388, 395 (4th Cir. 2013).

that the payment from Millennium to LSQ was not a transfer of an "interest of the debtor in property," as required by § 547(b) and § 548(a)(1). Accordingly, it found that the payment was not avoidable as either a preferential or a fraudulent transfer. The Trustee appealed, and the district court affirmed. This appeal followed.

II. ANALYSIS

"A summary judgment in a bankruptcy adversary proceeding is treated as any other summary judgment, so our review is de novo." *In re hhgregg, Inc.*, 949 F.3d 1039, 1044 (7th Cir. 2020). All reasonable factual inferences are made in favor of the non-movant—in this case, the Trustee. *Smith v. Cap. One Bank (USA), N.A.*, 845 F.3d 256, 259 (7th Cir. 2016). Having made those inferences, "[s]ummary judgment is appropriate if there is no genuine dispute of material fact and the nonmoving party is entitled to judgment as a matter of law." *In re Equip. Acquisition Res., Inc.*, 803 F.3d 835, 839 (7th Cir. 2015).

The parties focus, as the courts below did, on the "earmarking doctrine." We need not focus on the "earmarking doctrine" because a careful reading of the Bankruptcy Code's text and the application of our precedent resolve this case.

A. "An Interest of the Debtor in Property"

We begin with preferential transfers under § 547. Section 547 provides a mechanism for the trustee of a bankruptcy estate to "avoid"—claw back—transactions that favored certain creditors over others in the months before the debtor filed for bankruptcy. But § 547 only allows "the trustee ... [to] avoid ... transfer[s] of *an interest of the debtor in property*." (emphasis added). That language is key to this case.

In interpreting this phrase, the Supreme Court has explained that "the purpose of the avoidance provision is to preserve the property includable within the bankruptcy estate—the property available for distribution to creditors." *Begier v. I.R.S.*, 496 U.S. 53, 58-59 (1990). Accordingly, "interest of the debtor in property" is "best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings." *Warsco v. Preferred Tech. Grp.*, 258 F.3d 557, 564 (7th Cir. 2001) (quoting *Begier*, 496 U.S. at 58).

In *Matter of Smith*, we used two approaches to determine whether a transfer had affected "an interest of the debtor in property," asking: (1) whether the debtor can exercise control over the funds transferred; and (2) whether the transfer diminishes the property of the estate. *See* 966 F.2d 1527, 1535 (7th Cir. 1992). The goal of the two tests is the same: to determine whether the transfer took something from the pool of assets that would otherwise have gone to creditors. *See Matter of Wagenknecht*, 971 F.3d 1209, 1213 (10th Cir. 2020) (employing both tests for this purpose).

A debtor exercises control over transferred funds where he "determines the disposition of the funds *and* designate[s] the creditor to whom payment is made." *Matter of Smith*, 966 F.2d at 1535 (citations omitted and emphasis added). This is often a fact-intensive inquiry. As exemplified in *Warsco*, we must consider the totality of circumstances in determining control to ensure that debtors do not avoid liability by cleverly restructuring transactions. 966 F.2d at 1535. That being said, in this case, we are confident that a reasonable jury could find that Campion chose LSQ as the beneficiary of its new financing from Millennium and insisted on the transfer to perpetuate its Ponzi scheme. But there is scant evidence in the record of the second part of the *Matter of Smith* control analysis—that the Debtor, rather than Millennium or LSQ, had the ultimate ability to "determine[] the disposition of the funds" or of the accounts themselves.[3] Nor did the Trustee at any point before this Court argue that it met this standard.[4]

3. In fact, the Trustee himself explained that the accounts were under the "absolute ownership" of LSQ before ownership was "absolute[ly] transfer[red]" to Millennium. He described this transfer of ownership as "simultaneous[]" with the payment from Millennium to LSQ.

4. That makes sense when we read "interest of the debtor in property" as "coextensive with ... [its] use[] in 11 U.S.C § 541(a)(1)," as the Supreme Court requires. *Begier*, 496 U.S. at 59 n.3. Section 541 includes in the estate "all legal and equitable interests of the debtor in property." There is no evidence in the record that the Debtor had actual rights at law or equity to the $10.3 million or the accounts payable at the time of the transfer. Contra *Warsco*, 258 F.3d at 564 (remanding for further consideration on the control issue where the transfer involved assets legally owned by the debtor, meaning that the sale price of those assets could become part of the estate, and therefore the transfer may have involved "an interest of the debtor in property"). While Campion's alleged masterminding of the transfer might be enough to state a fraud claim, it is not enough to bring the transaction within the reach of the Bankruptcy Code.

At any rate, we do not need to decide the exact question of control here; a diminution of estate analysis shows plainly that the transaction at issue here did not involve "an interest of the debtor in property." The parties agree that neither the $10.3 million nor the accounts sold would have been part of the Debtor's estate. The funds never actually passed through the Debtor's accounts. And the change in creditors was instantaneous—as soon as LSQ released its security interest in the Debtor's invoices, Millennium received its security interest in those same invoices, making Millennium, not the Debtor, the owner of the accounts. As we described in *Matter of Smith*, Millennium "substitute[d] itself for the original creditor," LSQ, in every way. 966 F.2d at 1533. Our understanding is only emphasized by the Trustee's admission at oral argument that this transaction had "no adverse effect, no diminution ... on other creditors."

Because the transfer at issue did not involve "an interest of the debtor in property," it cannot be avoided as a preferential transfer under § 547.

B. Application Throughout the Bankruptcy Code

Nevertheless, the Trustee contends that these considerations are relevant only to the avoidance of preferential transfers under § 547. According to the Trustee, fraudulent transfers under § 548 do not require control over the transferred property or diminution of the estate; fraud alone is enough to make them avoidable. But the plain language of § 548 refutes this argument. Just like § 547's avoidance provision for preferential transfers, § 548(a)(1) permits "[t]he trustee [to] avoid any transfer

... of *an interest of the debtor in property*" that meets certain fraudulent criteria.[5] (emphasis added). So each of the Trustee's attempts to avoid this payment turn on the same question: whether the payoff agreement constituted an "interest of the debtor in property."

"Section 548's phrase 'an interest of the debtor in property,'" consistent with our reading of the phrase in § 547, "has generally been held to be the equivalent of 'property of the estate[,]'" encompassing "only those [transfers] that affect property that would have been property of the estate but for the transfer." 5 Collier on Bankruptcy ¶ 548.03 (16th 2023). Several factors convince us that this reading of § 548 is correct.

First, "[i]n general, we presume that 'identical words used in different parts of the same act are intended to have the same meaning.'" *White v. United Airlines, Inc.*, 987 F.3d 616, 623 (7th Cir. 2021) (quoting *Sullivan v. Stroop*, 496 U.S. 478, 484 (1990)). The courts that have considered the issue have held, in line with this general presumption, that the antecedent requirement for a transfer of "an interest of the debtor in property" should be applied identically across the avoidance provisions. *See In re Chase & Sanborn Corp.*, 813 F.2d 1177, 1181 (11th Cir. 1987) (interpreting "property of the debtor" to require diminution of the estate under both § 547 and

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5. As noted above, the Trustee also brought claims under § 544(b), but only mentions them in passing before this Court. Even if this were enough to preserve those claims for appeal, § 544(b) contains the same "interest of the debtor in property" prerequisite as § 547 and § 548. We read that language identically across all three provisions.

§ 548); *In re Chuza Oil Co.*, 639 B.R. 586, 604 (B.A.P. 10th Cir. 2022); *In re TriGem Am. Corp.*, 431 B.R. 855, 864 (Bankr. C.D. Cal. 2010); *In re Pearlman*, 460 B.R. 306, 313 (Bankr. M.D. Fla. 2011) (equating identical language in § 544 and § 548); *In re Loggins*, 513 B.R. 682, 697 n.51 (Bankr. E.D. Tex. 2014); *In re Baldwin*, 514 B.R. 646, 658 (Bankr. D. Utah 2014); *In re Dependable Auto Shippers, Inc.*, No. AP 17-3086, 2018 WL 4348049, at *6-7 (Bankr. N.D. Tex. Sept. 7, 2018); *In re Dandridge*, No. 17-60578, 2020 WL 2614615, at *2 (Bankr. W.D. Va. Jan. 31, 2020).

And although it has never confronted this specific question, controlling precedent from the Supreme Court supports identical readings of "interest of the debtor in property" throughout the Bankruptcy Code. As recently as 2018, the Court discussed §§ 544(a), 545, 547(b), and 548(a)(1) collectively as "avoiding powers," noting parallel language between the provisions. *See Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 888, 893-94 (2018) (discussing the avoiding powers in terms of their exceptions in § 546). And a consistent interpretation aligns with the Supreme Court's holding that "[e]quality of distribution among creditors is a central policy of the Bankruptcy Code." *Begier*, 496 U.S. at 58; *see also Chase*, 813 F.2d at 1181 ("The purpose of avoidance of both types of transfers [preferential and fraudulent] is to prevent a debtor from diminishing, to the detriment of some or all creditors, funds that are generally available for distribution to creditors."); 5 Collier on Bankruptcy ¶ 548.03 (referring to the "policy behind section 548" as "protecting and conserving *the debtor's estate* for creditors" (emphasis added)).

By focusing on diminution of the estate, our reading of § 548 properly rejects attempts to avoid transfers "where creditors would not otherwise have any reason or expectation to look to the assets transferred." *In re TriGem Am. Corp.*, 431 B.R. at 864; *see also* 5 Collier on Bankruptcy ¶ 548.03 ("[I]f a third party makes a transfer or incurs an obligation for the debtor's benefit, there is no fraudulent transfer because the third party's property typically would not become an estate asset and would not be available to the debtor's creditors."). Indeed, it seems that accepting the Trustee's interpretation here would place us in direct tension with the Code's focus on "equality of distribution among creditors." *Begier*, 496 U.S. at 58. The Trustee asks us to avoid the $10.3 million transfer, but that transfer went directly from Millennium to LSQ. Although the Trustee contends that avoidance would somehow make the transferred funds part of the Debtor's estate, he did not explain how. After all, the $10.3 million never passed through the Debtor's accounts in the first place, nor is there any suggestion in the record that Millennium would have paid the Debtor directly if the contract had not worked out with LSQ. Without some evidence connecting the transfer to the Debtor's estate, we can see only one way to reverse the payoff agreement alleged in this case: returning $10.3 million to Millennium. Put differently, avoiding this transfer would benefit the allegedly defrauded creditor and no others. That perverse result further assures us that § 548's use of "interest of the debtor in property" is identical to its use in § 547.

Finally, this decision aligns comfortably with those of our sister circuits, several of which have held or suggested that, even in the Ponzi scheme context, outright fraud alone cannot bring a transaction within the avoiding powers of the Bankruptcy Code—the baseline avoiding requirements of the statute must still be met. *See In re Whitley*, 848 F.3d 205, 208 (4th Cir. 2017) (where fraudulent transactions in the course of a Ponzi scheme were not "transfers" within the meaning of § 548, the transactions could not be avoided by the Trustee); *In re Fair Fin. Co.*, 13 F.4th 547, 553 (6th Cir. 2021), reh'g denied (Oct. 5, 2021) (similar holding in the Ponzi scheme context based on § 544 and the Ohio state law definition of "transfer"); *Isaiah v. JPMorgan Chase Bank*, 960 F.3d 1296, 1302 (11th Cir. 2020) (similar holding in the Ponzi scheme context based on Florida state law definition of "transfer," and acknowledging that this state law has similar avoidance requirements to § 548).

The Trustee does not address any of these points. Instead, he maintains that considering control and diminution of the estate in the context of § 548(a) creates conflict elsewhere in the provision. He points to the "good faith" defense under § 548(c), for example, as well as the distinctions between actual fraud under § 548(a)(1)(A) and constructive fraud under § 548(a)(1)(B).[6] We see no conflict between these provisions and our interpretation

6. The Trustee also focused on § 547(c)'s "new value" exception to preferential transfers as a statutory replacement for any requirement of diminution of property in the avoidance statutes. But this argument was never made below and was therefore, at a minimum, forfeited. *Henry v. Hulett*, 969 F.3d 769, 786 (7th Cir. 2020) (en banc). The Trustee has given no indication that these are the kind of "exceptional circumstances" under which we are willing to review a forfeited argument. *Id.* And so we need not address this here.

of "an interest of the debtor in property." In fact, our opinion does not impact those provisions at all—Congress clearly included powerful tools against debtor fraud within § 548, and they should be enforced whenever applicable. We address only the antecedent question of what kinds of transfers affect the bankruptcy estate in the first place. Within that subset of transfers, questions about good faith, actual fraud, and constructive fraud under § 548(c), § 548(a)(1)(A), and § 548(a)(1)(B), respectively, determine which transfers can be avoided.

Because the transaction in this case had no impact on the property of the Debtor, this is not the type of fraud governed by the Bankruptcy Code. If fraud occurred, Millennium's relief should come from damages in a separate fraud suit.[7]

III. CONCLUSION

Attempts to avoid both preferential and fraudulent transfers require a showing that the transfers involved "an interest of the debtor in property." The Trustee in this case concedes that the transfer at issue here did not diminish the Debtor's estate. Under our established precedent, this means he failed to show that the transfer involved "an interest of the debtor in property." Accordingly, he cannot avoid the $10.3 million transaction, and the judgment of the district court is

AFFIRMED.

7. As we understand it, fraud claims brought by Millennium against LSQ and Engstrom are ongoing in Florida state court.

APPENDIX B — OPINION OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF WISCONSIN, DATED JULY 15, 2022

UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF WISCONSIN

Case No. 21-cv-1070-bhl

DOUGLAS F. MANN, CHAPTER 7
TRUSTEE OF ESTATE OF ENGSTROM, INC.,

Appellant,

v.

LSQ FUNDING GROUP, L.C.,

Appellee.

July 15, 2022, Decided

DECISION AND ORDER

Trustee Douglas F. Mann appeals an August 31, 2021 bankruptcy court order granting summary judgment in favor of LSQ Funding Group L.C. (LSQ) on the Trustee's fraudulent conveyance and preference claims. *See Douglas F. Mann as Chapter 7 Trustee of the Estate of Engstrom, Inc. v. LSQ Funding Group, L.C.* (*In re Engstrom, Inc.*), Case No. 20-22839-kmp, Adversary No. 20-2062-kmp (Bankr. E.D. Wis. 2021). Because the bankruptcy court correctly applied the earmarking and diminution of the estate doctrines to dismiss the Trustee's adversary claims, the appeal fails and the bankruptcy court's decision is affirmed.

FACTUAL AND PROCEDURAL BACKGROUND

Before its April 2020 bankruptcy filing, Debtor Engstrom, Inc. was a temporary staffing agency. R. 4-4 at 68. It was, for several years prior to its bankruptcy, and until January 2020, party to a factoring agreement with LSQ. *Id.* at 77. Factoring, also known as accounts receivable or invoice financing, is an arrangement by which a business obtains credit based on funds the business expects to receive from its customers. *Id.* at 279. Engstrom entered into such an arrangement with LSQ.

Under the parties' Invoice Purchase Agreement (IPA), Engstrom would issue invoices to its customers for temporary staffing services and then submit those invoices to LSQ for purchase. Upon acceptance, LSQ would advance Engstrom approximately 85% of the face amount of the purchased invoices. After LSQ received payment from Engstrom's customer, Engstrom would ask LSQ to forward the remainder of the face amount of the paid invoice, less the amounts owed to LSQ under the IPA. *Id.* at 145-59. To secure its obligations, Engstrom granted LSQ a first priority security interest in all of its personal property and fixtures, and the proceeds thereof, including all accounts. *Id.* at 145, 151-59.

On January 9, 2020, LSQ terminated the IPA and demanded payment of the $10,272,501.68 then due from Engstrom. R. 4-4 at 68-69. LSQ also exercised its contractual right to require Engstrom to repurchase all unpaid and outstanding invoices. *Id.* at 146.

Two weeks later, on January 23, 2020, Engstrom entered into a new factoring agreement with Canfield Funding LLC, d/b/a Millennium Funding (Millennium). *Id.* at 280-81, 287-304. The Millennium Agreement "was designed to operate like a standard factoring agreement: once the Debtor submitted invoices to its customers and Millennium, Millennium would advance 85% of the face value of the invoices to the Debtor. After Millennium received payment directly from the Debtor's customers, it would advance the remaining 15%, less any fees set forth in the contract." *Id.* at 281.

On January 27, 2020, LSQ sent a payoff letter to Millennium and Cherie Campion, Engstrom's chief executive officer, confirming Engstrom's debt to LSQ was (as of the next day) $10,306,661.56. R. 4-4 at 19-20, 306-07. Millennium signed the letter, accepting its terms, and returned it to LSQ. *Id.* at 307. Two days later, on January 29, 2020, Millennium paid LSQ the $10,306,661.56 via wire transfer. *Id.* at 210. After receiving the payment, LSQ released all of its interests in Engstrom's invoices and other assets. *Id.* at 79.

As part of its deal with Millennium, Engstrom agreed that the funds being sent to LSQ could only be used to pay Engstrom's debt to LSQ; Engstrom had no discretion to transfer those funds to any other person or entity. R. 4-4 at 211-12, 218, 228. The transfer eliminated Engstrom's debt to LSQ, replacing it with a debt to Millennium. *Id.* at

211. In exchange, Millennium received a security interest in the collateral previously pledged to LSQ. *Id.* at 218. After the transaction, LSQ had no interest in Engstrom's accounts. *Id.* at 148, 183.

According to the Trustee, Millennium later discovered that Campion and Engstrom had perpetrated a fraud. Millennium received its first payment for invoices it purchased from Engstrom via a wire transfer from an account in the name of NextEra Renewable ES, LLC. R. 4-4 at 275. Millennium tried but was unable to verify that the payor was a legitimate subsidiary of NextEra, Inc., Engstrom's largest customer. *Id.* at 274-75, 282. It then discovered that the account signatory was actually *Campion* and that NextEra Renewable ES, LLC was not a legitimate NextEra subsidiary. *Id.* at 282-83. When confronted, Campion admitted Engstrom actually had only about $12,000 in legitimate invoices. She further revealed she had created a fictional individual to verify the fraudulent invoices and had used voice-altering technology to appear as the fictional individual, with fraudulent phone and fax numbers. *Id.* at 275-76.

Millennium maintains that Engstrom and Campion were engaged in a fraudulent Ponzi scheme through which they sold fake invoices to Engstrom's factor and obtained advances that were then used to pay off previously purchased invoices. The downward debt spiral continued because Engstrom continually fell behind as its factor would never pay the entire face value of the invoices given the deduction of contractual factoring fees. R. 4-4 at 276.

On April 15, 2020, Engstrom filed a Chapter 11 bankruptcy petition. R. 4-2 at 1-31. Shortly thereafter, Engstrom filed an adversary proceeding against LSQ, contending the payment Millennium made to LSQ to pay off the Engstrom debt was a voidable preference. R. 4-4 at 1-3. The adversary complaint was later amended to add fraudulent transfer claims as well. R. 4-4 at 9-14; *see also* R. 4 at 44. LSQ and the United States Trustee filed separate motions to have: (1) the bankruptcy case dismissed; (2) a trustee appointed; or (3) the case converted to Chapter 7. With these motions pending, Engstrom stipulated to convert the case to Chapter 7. *See* R. 4 at 12, 23, 30. After a Chapter 7 Trustee was appointed, the Trustee obtained court permission to employ Engstrom's bankruptcy counsel to continue the adversary proceeding. *See id.* at 32, 36.

On March 25, 2021, LSQ moved for summary judgment on the Trustee's claims. R. 4-4 at 111-12. Five months later, on August 31, 2021, the bankruptcy court issued a decision and order granting LSQ's motion for summary judgment and dismissing the Trustee's claims. R. 4-6 at 22-61. In a detailed analysis, the bankruptcy court applied long-established Seventh Circuit law concerning the "earmarking" and "diminution of the estate" doctrines to conclude that Engstrom lacked an interest in the Millennium payment made to LSQ and that the payment had not diminished Engstrom's bankruptcy estate. Because the Trustee could therefore not establish an essential element of its avoidance claims, the bankruptcy court granted LSQ summary judgment.

ANALYSIS

This Court has jurisdiction over the appeal of the bankruptcy court's order under 28 U.S.C. § 158(a). The bankruptcy court's decision to grant summary judgment is reviewed *de novo. In re Midway Airlines, Inc.*, 383 F.3d 663, 668 (7th Cir. 2004). A grant of summary judgment will be affirmed if "there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a). Summary judgment may be affirmed on any ground supported by the record, even if it was not relied upon by the court below. *Midway Airlines*, 383 F.3d at 668.

The Trustee asserts the bankruptcy court's summary judgment decision should be reversed for four reasons. First, the Trustee contends the bankruptcy court erred in refusing to allow equitable considerations, specifically LSQ's alleged "unclean hands," to override the court's application of the earmarking doctrine. Second, the Trustee insists the bankruptcy court mistakenly applied the earmarking doctrine to a factoring relationship. Third, the Trustee challenges the bankruptcy court's conclusion that the Debtor's estate was not diminished by the Millennium payment. Fourth, and finally, the Trustee argues the bankruptcy court should not have applied either the earmarking or diminution of the estate doctrines to the Trustee's fraudulent transfer claims. As explained below, the bankruptcy court correctly applied the law, and its decision will therefore be affirmed.

I. The Bankruptcy Court Did Not Err in Refusing to Use Equitable Considerations to Override the Earmarking Doctrine.

The Trustee's lead argument is that the bankruptcy court erred in rejecting the Trustee's invitation to use equitable considerations to cancel out application of the earmarking doctrine. ECF No. 6 at 23-31. According to the Trustee, LSQ possessed unclean hands—or, at minimum, there is a genuine dispute as to LSQ's inequitable conduct—making summary judgment on its avoidance claims inappropriate. *Id.* at 24.

The Trustee's argument fails to understand the bankruptcy court's analysis. The bankruptcy court was well aware of the Trustee's (and Millennium's) position that Engstrom's debts to both LSQ and Millennium were the result of a fraudulent scheme perpetrated by Engstrom and its CEO, Campion. R. 4-6 at 27, 42. The court also understood that the challenged payment—from Millennium to LSQ on the debtor's behalf—left Millennium (rather than LSQ) holding the bag for the scheme. *Id.* But the bankruptcy court correctly concluded that this scheme was legally irrelevant under the Bankruptcy Code provisions applicable to the Trustee's claims. *Id.* at 42-43.

The Trustee brings avoidance claims under section 547(b) (preferences), section 548(a)(1) (fraudulent transfers and obligations), and section 544(b) (avoiding certain prepetition transfers). As applicable to this adversary proceeding, all three sections require proof of a "transfer of an interest of the debtor in property." Absent such a transfer, the Trustee's claims under these sections fail. *See* 5 Collier on Bankruptcy ¶¶544.01, 547.03[1], 548.03[2] (16th ed. 2022).

As the bankruptcy court explained, the earmarking doctrine is a well-established legal principle that confirms that certain transactions do not involve transfers of a debtor's interest in property. Specifically, the doctrine confirms that when a new lender makes a loan to a debtor for the specific purpose of paying off a former lender, the debtor has not made a transfer of its own property because the debtor still owes the same sum, only to a different creditor. *See* 5 Collier on Bankruptcy ¶547.03[2][a]. In the words of the bankruptcy court: "'In such circumstances the payment is 'earmarked' and the third party simply substitutes itself for the original creditor. Such a transfer is said not to be a preferential transfer because (1) the debtor never exercises 'control' over the new funds; and (2) the debtor's property (i.e., the fund out of which creditors can be paid) is not diminished.'" R. 4-6 at 31 (quoting *In re Smith*, 966 F.2d 1527, 1533 (7th Cir. 1992)).

The bankruptcy court correctly observed that there is no dispute that Millennium paid LSQ to satisfy an antecedent debt, Engstrom had not exercised any "control" over the transferred funds, and the transaction had no effect or "diminution" on Engstrom's bankruptcy. R. 4-6 at 33. Accordingly, the earmarking doctrine applied to except the Millennium payment from Engstrom's bankruptcy estate.

Because Engstrom never had an interest in those funds, the bankruptcy court was correct in concluding that the funds were not subject to the Trustee's avoidance claims and this conclusion remains valid irrespective of any underlying fraud by Engstrom and Campion. If the debtor had no interest in the transferred property, then alleged inequitable conduct by the transferee related to that property is irrelevant. The Trustee cites no caselaw in which a court has used "unclean hands" or any other equitable principle to allow avoidance of a transfer in which the debtors lack an interest in the transferred property.

Neither the Trustee's lengthy discussion of the earmarking doctrine's history nor his plaintive cries for equity alters the fundamental point that Engstrom never had an interest in the Millennium payment. ECF No. 6 at 26-31. Anything questionable in LSQ's interactions with Millennium is a matter between those creditors and any such allegations have no bearing on Engstrom's bankruptcy estate.[1] In sum, there is nothing legally incorrect, or inequitable, about the bankruptcy court's application of the plain terms of sections 544, 547, and 548 and the earmarking doctrine to reject the Trustee's avoidance claims.

1. The Court does not rule on any non-bankruptcy remedy Millennium may have against LSQ for any misrepresentations it made relating to the Engstrom/Campion fraud and the payoff transaction. The Trustee's brief suggests LSQ actually remained silent and made no representations to Millennium concerning its exit from the Engstrom factoring relationship. Regardless, whether Millennium's misfortune was the result of its own poor due diligence or fraud is not a matter for this bankruptcy case.

II. The Trustee's Tardy Assertion that the Earmarking Doctrine Does Not Apply to Factoring Transactions Is Not Timely Raised and, in Any Event, Is Legally Wrong.

The Trustee next argues the bankruptcy court should not have applied the earmarking doctrine at all because Millennium's payment involved the payoff of a factoring transaction. ECF No. 6 at 32-36. The Trustee urges the Court to adopt a rule limiting application of the doctrine to "typical loan transactions" and reject its application to factoring arrangements like the one at issue here. *Id.* at 33. According to the Trustee, the bankruptcy court failed to account for the fact that Engstrom sold its accounts receivable to LSQ only to have LSQ demand that Engstrom repurchase those accounts receivable when it terminated the parties' agreement. The Trustee criticizes the bankruptcy court for improperly focusing on the wire transfer from Millennium to LSQ, when the $10,306,661.56 in essence represented proceeds from Engstrom's sale of its accounts receivable to Millennium. *Id.* at 34-35. It insists that "[a]lthough the Bankruptcy Court acknowledged the purchase and sale of the accounts, it did not consider their import in connection with the application of the earmarking doctrine. Had it done so, it would have concluded that the Debtor necessarily had an interest in the $10.3 million paid to LSQ in order to repurchase the accounts receivable." ECF No. 8 at 16.

LSQ's first response to this diatribe is procedural. LSQ objects that the Trustee did not argue in the bankruptcy court that the underlying factoring arrangement made the earmarking doctrine inapplicable and, accordingly, cannot pursue this position on appeal. ECF No. 7 at 46-48. It points to repeated concessions by the Trustee that the payoff was a loan—both in discovery responses and briefing—without ever suggesting that the factoring arrangement made the payoff anything other than a loan transaction. ECF No. 7 at 47 (citing Trustee Resp., R 4-4 at 410 (arguing Debtor "controlled the proceeds of the loan"); Wronski Decl., Ex. B, R 4-4 at 219 & 225, Resp. to Interrog. No. 7 (answering "Millennium transferred $10,306,661.56 to LSQ on behalf of the Debtor" and "[t]hose funds represented a loan from Millennium to the Debtor") & Resp. to Req. for Admis. No. 3 ("Plaintiff admits that the wire transfer of $10,306,661.56 that LSQ received on January 29, 2020 originated from an account owned or controlled by Millennium. By way of further response, the wire transfer to LSQ represented the proceeds of a loan between Millennium and the Debtor.")).

Normally "a party waives the ability to make a specific argument for the first time on appeal when the party failed to present that specific argument to the [bankruptcy] court, even though the issue may have been before the [bankruptcy] court in more general terms." *Homoky v. Ogden*, 816 F.3d 448, 455 (7th Cir. 2016) (citation omitted). An appellate court has "the discretion to take up these issues in the first instance, 'but to say that an appellate court *may* address an issue that was forfeited in the district court is not to say that it *must*.'" *Soo Line R.R. Co. v. Consol. Rail Corp.*, 965 F.3d 596, 601 (7th Cir. 2020) (citing *Singleton v. Wulff*, 428 U.S. 106, 121 (1976); quoting *Builders NAB LLC v. FDIC*, 922 F.3d 775, 778 (7th Cir. 2019)).

Here, the Trustee is trying to advance a new position on appeal. He points to nothing in the record showing he ever suggested to the bankruptcy court that it should create a factoring exception to the earmarking doctrine. In reply, he admits he referred to the payoff as a loan "at times." ECF No. 8 at 14. But he insists the factoring arrangement was no secret in the bankruptcy court. *Id.* This reply misses the point. That no one disputed the existence of a factoring arrangement before the bankruptcy court is not the same as arguing, as the Trustee does on appeal, that the earmarking doctrine does not apply at all to factoring arrangements. The argument is therefore waived.

For the avoidance of doubt, however, even in the absence of waiver, the Court agrees with LSQ that the earmarking doctrine applies in the context of factoring arrangements. As explained by the bankruptcy court:

> On January 29, 2020, LSQ received a wire transfer in the amount of $10,306,661.56 from an account owned or controlled by Millennium. Upon receipt of the payment from Millennium, LSQ released all of its interest in the Debtor's invoices and other assets. The Debtor had no discretion to transfer the funds that LSQ received on January 29, 2020 to any person or entity other than LSQ. The Debtor and Millennium had an agreement whereby the funds that Millennium sent to LSQ by wire transfer would be used only to pay the debt that the Debtor owed to LSQ. After the transfer,

> the Debtor no longer owed a debt to LSQ but was indebted to Millennium in an amount not less than $10,306,661.56. Millennium received as collateral the collateral that had previously secured the Debtor's debt to LSQ. After the transaction, LSQ no longer had an interest in the Debtor's accounts.

R. 4-6 at 26-27 (internal citation omitted). This is a textbook application of the earmarking doctrine. Simply because the financial transaction at issue was born of a factoring agreement instead of a more conventional loan does not change the analysis.

III. The Bankruptcy Court's Diminishment of the Estate Analysis Was Not Erroneous.

The Trustee's third argument is that the bankruptcy court incorrectly concluded that the Debtor's bankruptcy estate was not diminished by the transfer, based on the court's error in "casting this transaction in terms of a routine loan refinancing, instead of a factoring arrangement." ECF No. 6 at 36-39. Had the bankruptcy court considered the transaction under factoring principles, the Trustee contends, it would have concluded that the estate was diminished because (1) the Millennium Agreement imposed a higher base factoring fee than the LSQ Agreement, (2) the Millennium Agreement imposed an additional concentration factoring fee over eight times the cost of LSQ's base factoring fee, and (3) the payoff to LSQ also included LSQ's factoring fee, resulting in a "second factoring fee" applied against the purchased invoices. *Id.* at 37-39.

This Court disagrees. Applying the underlying principles set forth by the Seventh Circuit in *Smith*, 966 F.2d 1527, the Bankruptcy Court explained its reasoning:

> Before the wire transfer, the Debtor owed LSQ \$10,306,661.56 and had granted it a security interest in its accounts. After the wire transfer, the Debtor owed Millennium the same amount, \$10,306,661.56 and had granted it a security interest in the same collateral. The transaction simply involved Millennium, as the new creditor, using its funds to step into the shoes of LSQ, as the old creditor, with no net impact on the estate. The new loan with Millennium did not deprive the Debtor's bankruptcy estate of something that could otherwise be used to satisfy the claims of its other creditors. The proceeds of this loan were not available for distribution to the Debtor's creditors. The Debtor had no ability or discretion to transfer the \$10,306,661.56 wire transfer to any person or entity other than LSQ. Millennium was simply substituted for LSQ with respect to the debt the Debtor previously owed to LSQ. Had the transfer not been made, the Debtor's assets and total obligations would have remained exactly the same — only the identity of the Debtor's primary creditor would have changed.

R. 4-6 at 48. Again, this Court finds no error in the bankruptcy court's analysis.

The bankruptcy court correctly recognized that, while the Bankruptcy Code does not contain an explicit diminution of the estate requirement, courts—including the Seventh Circuit—require a plaintiff in an avoidance action to prove that the transfer resulted in diminution of the debtor's bankruptcy estate. R. 4-6 at 43 (citing *Smith*, 966 F.2d at 1535). The bankruptcy court then analyzed the transaction at issue. It concluded that the challenged transaction did not result in a "diminution of the debtor's estate," based upon the following undisputed facts: (1) immediately before LSQ's receipt of the wire transfer of $10,306,661.56 on January 29, 2020, the Debtor was indebted to LSQ in an amount equal to $10,306,661.56; (2) immediately after LSQ's receipt of the wire transfer, the Debtor was no longer indebted to LSQ in any amount; (3) immediately after Millennium's initiation of the $10,306,661.56 wire transfer to LSQ, the Debtor was indebted to Millennium in the same amount; (4) the Debtor had no ability or discretion to transfer the $10,306,661.56 wire transfer to any person or entity other than LSQ; and (5) the collateral in which Millennium received a security interest from the Debtor to secure repayment of the $10,306,661.56 remitted to LSQ was the same collateral that secured repayment of the Debtor's obligations to LSQ before LSQ's receipt of the $10,306,661.56 wire transfer from Millennium. *Id.* at 47-48.

Finding that Millennium's payoff of the $10.3 million factoring agreement that the Debtor had with LSQ did not result in depletion or diminution of the Debtor's estate, the bankruptcy court concluded there had been no transfer of an interest of the debtor in property and, consequently, the transfer of funds from Millennium to

LSQ was not avoidable. R. 4-6 at 49. The bankruptcy court rejected the Trustee's argument that the Debtor's estate was diminished when it entered into the Millennium Agreement, which purportedly imposed higher factoring fees than the LSQ Invoice Purchase Agreement. *Id.* at 49-52. Comparing the Debtor's pre-transfer property to its post-transfer property, the bankruptcy court found that none of the fees diminished the pool of assets available to creditors. *Id.* at 51. None of these findings or conclusions was in error.

IV. The Bankruptcy Court Properly Concluded the Earmarking and Diminution of Estate Doctrines Applied to Claims Under 11 U.S.C. § 548(a)(1)(A).

The Trustee's final argument is that the bankruptcy court erred when it applied the earmarking and diminution of the estate doctrines to intentionally fraudulent transfer claims under 11 U.S.C. § 548(a)(1)(A). ECF No. 6 at 39-43. The Trustee contends that since diminution of the estate (the lack of which may justify application of the earmarking doctrine) is not an element of an intentionally fraudulent transfer, the bankruptcy court improperly required the Trustee prove an additional element (diminution of the estate) not otherwise required by statute. *Id.* at 41.

This Court rejects this argument too. The bankruptcy court correctly held that the "diminution of the estate doctrine" applied to intentionally fraudulent transfers under section 548. R. 4-6 at 58-61. This section of the Bankruptcy Code allows a trustee to avoid "any transfer of an interest of the debtor in property" or any obligation incurred by the debtor that was made or incurred on or within two years of the date of the filing of the petition if the debtor voluntarily or involuntarily "made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted." 11 U.S.C. § 548(a)(1)(A). To prevail on a claim under section 548(a)(1), the Code explicitly requires the Trustee prove a "transfer ... of an interest [or obligation] of the debtor in property." There are no exceptions to this requirement. Therefore, as a matter of law, when a debtor does not have an interest in the property transferred—whether demonstrated by the earmarking doctrine, diminution of the estate doctrine, or otherwise—there can be no fraudulent transfer claim. The bankruptcy court correctly applied the law.

CONCLUSION

In sum, the Court agrees with and adopts the reasoning and analysis of the bankruptcy court as set forth in its August 31, 2021 decision. For the reasons stated above, the Order and Judgment of the Bankruptcy Court Granting LSQ Funding Group, L.C.'s Motion for Summary Judgment in *Douglas F. Mann as Chapter 7 Trustee of the Estate of Engstrom, Inc. v. LSQ Funding Group, L.C.*, Adversary No. 20-2062-kmp, are AFFIRMED.

Dated at Milwaukee, Wisconsin on July 15, 2022.

/s/ *Brett H. Ludwig*
BRETT H. LUDWIG
United States District Judge

APPENDIX C — OPINION OF THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF WISCONSIN, FILED AUGUST 31, 2021

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF WISCONSIN

Chapter 7
Case No. 20-22839-kmp

IN RE:

ENGSTROM, INC.,

Debtor.

Adv. No. 20-2062

DOUGLAS F. MANN, AS CHAPTER 7 TRUSTEE OF THE ESTATE OF ENGSTROM, INC.,

Plaintiff,

v.

LSQ FUNDING GROUP, L.C.,

Defendant.

DECISION AND ORDER GRANTING DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

The Chapter 7 Trustee for the estate of Engstrom, Inc. (the "Debtor") has sued LSQ Funding Group, L.C. ("LSQ") to avoid and recover an alleged preferential transfer under 11 U.S.C. § 547 and an alleged fraudulent transfer under 11 U.S.C. §§ 544 and 548. The transfer in dispute in this case is a $10,306,661.56 wire transfer made by Canfield Funding LLC (d/b/a Millennium Funding) ("Millennium") to defendant LSQ to pay off a factoring agreement debt the Debtor owed to LSQ. LSQ has moved for summary judgment, arguing that the "earmarking" doctrine applies, and because the Debtor did not exercise any control over the transfer, because the transaction did not diminish the Debtor's estate, and because the transaction simply substituted Millennium for LSQ as the Debtor's principal creditor, the Trustee cannot establish a "transfer of an interest of the debtor in property," which is an essential element of each of the Trustee's claims. For the reasons discussed below, the Court hereby grants LSQ's motion for summary judgment and dismisses the Trustee's claims.

Statement of Jurisdiction

The Court has jurisdiction over the Motion pursuant to 28 U.S.C. § 1334 and the order of reference from the district court pursuant to 28 U.S.C. § 157(a). *See* Order of Reference (E.D. Wis. July 10, 1984) (available at www.wied.uscourts.gov/gen-orders/bankruptcy-matters) (last accessed August 31, 2021). As a proceeding to determine, avoid, or recover a preference and/or a fraudulent conveyance, this is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(F) and (H) and 28 U.S.C. § 157(b)(1) permits entry of a final judgment. Both the Chapter 7 Trustee and LSQ have consented to the entry of final orders or judgment by the Bankruptcy Court.

Appendix C

Summary Judgment Standard

Summary judgment is only appropriate "if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a); Fed. R. Bankr. P. 7056. To be "material," a fact must be "outcome-determinative under governing law." *Contreras v. City of Chicago*, 119 F.3d 1286, 1291 (7th Cir. 1997). For a factual dispute to be "genuine," the evidence must be "such that a reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). In determining whether there is a genuine issue of material fact, the Court must construe facts and inferences in a light most favorable to the nonmoving party. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587-88 (1986). At the summary judgment stage, the role of the court is not to weigh evidence, but to determine whether there is a genuine issue for trial. *See Anderson*, 477 U.S. at 249.

Here, the Chapter 7 Trustee has the burden of proof on his preference claim and his fraudulent transfer claims. 11 U.S.C. § 547(g); *Mottaz v. Oswald (In re Frierdich)*, 294 F.3d 864, 867 (7th Cir. 2002). Defendant LSQ has filed the summary judgment motion. A moving party that does not bear the burden of proof may succeed on summary judgment "by 'showing' — that is, pointing out to the [] court — that there is an absence of evidence to support the non-moving party's case." *Celotex Corp. v. Catrett*, 477 U.S. 317, 325 (1986). If the moving party does so, the non-moving party "must set forth specific facts showing that there is a genuine issue for trial" and "may not rest upon the mere allegations or denials of his pleading." *Anderson*, 477 U.S. at 248. Put differently,

> [i]f the moving party demonstrates to the court that the nonmoving party's evidence is insufficient to establish an essential element of the nonmoving party's claim, and the nonmoving party cannot muster sufficient evidence to make out its claim, a trial would be useless and the moving party is entitled to summary judgment as a matter of law.

Marcial v. Coronet Ins. Co., 880 F.2d 954, 959 (7th Cir. 1989).

Statement of Facts

The Debtor previously conducted business as a staffing agency that provided temporary staff to its clients. Second Amended Complaint and Answer, ¶ 6. LSQ, the defendant in this adversary proceeding, had a factoring relationship with the Debtor between January 2015 and January 2020. Answer, ¶ 8. Accounts receivable financing, also known as "factoring," or "invoice financing," is a financing solution that provides a client with a line of credit based on the funds it expects to receive from its customers. Declaration of John Benkovich, ¶ 5 (Docket No. 66). LSQ and the Debtor entered into such a factoring agreement, called an Invoice Purchase Agreement ("IPA"), on June 11, 2018. Second Amended Complaint and Answer, ¶ 8; Declaration of Carrie Bailey, ¶ 6, Ex. A (Docket No. 50). According to

Carrie Bailey, a portfolio manager for LSQ, the factoring relationship worked as follows:

> The Debtor would issue invoices to its customers for temporary staffing services. The Debtor would submit those invoices to LSQ for purchase. . . . Upon acceptance, LSQ would advance the Debtor approximately 85% of the face amount of the purchased invoices. Once LSQ received payment from the Debtor's customer on a purchased invoice, the Debtor could request that LSQ send the Debtor the remainder of the face amount of the paid invoice, less the amounts owed to LSQ under the IPA.

Bailey Dec., ¶ 7; *see also* Second Amended Complaint at ¶ 8 ("the Debtor would invoice its customers, and the Defendant would then purchase the invoices from the Debtor in exchange for an advance/loan in a percentage of the face amount of the account."). To secure payment and performance of all obligations of the Debtor to LSQ, the Debtor granted LSQ a first priority security interest in all of its personal property and fixtures and the proceeds thereof, including all accounts. Bailey Dec., ¶ 6, Ex. A.

On January 9, 2020, LSQ sent a letter to the Debtor terminating the IPA with the Debtor and demanding that the Debtor pay LSQ $10,272,501.68, the outstanding amount due to LSQ pursuant to the IPA as of January 9, 2020. Second Amended Complaint and Answer at ¶ 11. Pursuant to Section 8 of the IPA, LSQ exercised its contractual right to require that the Debtor repurchase all unpaid and outstanding invoices that LSQ had purchased from the Debtor. Bailey Dec., ¶ 10.

On January 23, 2020, the Debtor entered into a factoring agreement with Millennium pursuant to which the Debtor sold its accounts receivable to Millennium. Benkovich Dec., ¶ 14, Ex. A. The Millennium Agreement "was designed to operate like a standard factoring agreement: once the Debtor submitted invoices to its customers and Millennium, Millennium would advance 85% of the face value of the invoices to the Debtor. After Millennium received payment directly from the Debtor's customers, it would advance the remaining 15%, less any fees set forth in the contract." *Id.* at ¶¶ 6, 15.

On January 27, 2020, LSQ addressed a payoff letter to Millennium's chief financial officer and also to the attention of Cherie Campion, the Debtor's chief executive officer. Benkovich Dec., ¶¶ 19-21, Ex. B; Bailey Dec., Ex. E. The president of Millennium accepted and agreed to the terms of the payoff letter, executed it, and returned the letter to LSQ. *Id.* The payoff letter stated and the parties agreed that the Debtor owed LSQ $10,306,661.56 on January 28, 2020. *Id.*; Declaration of Andrew J. Wronski, Ex. B, Request to Admit No. 6 (Docket No. 51-2).

On January 29, 2020, LSQ received a wire transfer in the amount of $10,306,661.56 from an account owned or controlled by Millennium. Wronski Dec., ¶ 3, Ex. B, Reqs. to Admit Nos. 2, 3. Upon receipt of the payment from Millennium, LSQ released all of its interest in the

Debtor's invoices and other assets. Second Amended Complaint and Answer, ¶ 14; Bailey Dec. ¶ 16, Ex. H-I.

The Debtor had no discretion to transfer the funds that LSQ received on January 29, 2020 to any person or entity other than LSQ. Wronski Dec., Ex. C, Supplemental Request to Admit No. 12, Interrogatory No. 17 (Docket No. 51-3). The Debtor and Millennium had an agreement whereby the funds that Millennium sent to LSQ by wire transfer would be used only to pay the debt that the Debtor owed to LSQ. Wronski Dec., Ex. B, Req. to Admit No. 9. After the transfer, the Debtor no longer owed a debt to LSQ but was indebted to Millennium in an amount not less than $10,306,661.56. *Id.*, Reqs. to Admit Nos. 7-8. Millennium received as collateral the collateral that had previously secured the Debtor's debt to LSQ. *Id.*, Response to Interrog. No. 20. After the transaction, LSQ no longer had an interest in the Debtor's accounts. Bailey Dec. ¶ 16, Ex. H-I.

The affidavits submitted by the Trustee in response to LSQ's motion for summary judgment go on to describe the alleged fraud perpetuated on Millennium by Ms. Campion. Millennium asserts that, on February 12, 2020, it received its first payment for invoices issued by the Debtor and purchased under the Millennium Agreement via a wire transfer from an account in the name of NextEra Renewable ES, LLC. Declaration of Tim Sardinia, ¶ 15 (Docket No. 58). Millennium attempted to verify that NextEra Renewable ES, LLC was a legitimate subsidiary of NextEra, Inc., the Debtor's largest customer. *Id.* at ¶¶ 13, 16; Benkovich Dec., ¶ 26. It was unable to do so. *Id.*

When Millennium went to the bank to obtain information about the NextEra Renewable ES, LLC account, it discovered the account signatory was Ms. Campion and realized that NextEra Renewable ES, LLC was not a legitimate subsidiary of NextEra. Benkovich Dec., ¶ 27. Millennium further alleges that when it confronted Ms. Campion, she admitted that the Debtor only had $12,000 in legitimate invoices, that she was able to perpetuate the scheme by creating a fictional individual to verify the fraudulent invoices, that she used voice-altering technology to appear as this fictional individual, and that this fictional individual's phone and fax number appeared to relate to NextEra but were in fact owned and controlled by her. Sardinia Dec., ¶¶ 19, 22. Millennium believes that the Debtor perpetuated a fraudulent scheme that operated like a Ponzi scheme, where the Debtor would sell fake invoices to its factor, the factor would then remit the advance, the Debtor would then use the advance to pay off invoices previously purchased by the factor, with the Debtor continually falling behind because the factor would never pay the entire face value of the purchased invoice because of the contractual factoring fees. *Id.* at ¶ 23.

The Debtor filed a voluntary Chapter 11 bankruptcy petition a few short weeks later on April 15, 2020. The Debtor's list of the 20 largest creditors holding unsecured claims included only one creditor, Millennium. The creditor matrix included only Ms. Campion and her husband, the Internal Revenue Service, the Wisconsin Department of Revenue, the Debtor's lawn care company, 10 temporary workers who were owed wages, and Millennium. Shortly after the bankruptcy filing, the Debtor filed this adversary proceeding against LSQ to recover the allegedly preferential payment made by Millennium to LSQ.

LSQ filed a motion to dismiss the bankruptcy case on May 1, 2020. On June 18, 2020, the United States Trustee filed a motion requesting an order directing the appointment of a Chapter 11 trustee, or, alternatively, conversion of the case to Chapter 7. On the eve of the hearing on the United States Trustee's and LSQ's motions, the Debtor amended its complaint to assert fraudulent transfer claims against LSQ as well as the preference claim. Several hours after filing the amended complaint, the Debtor filed a stipulation with the United States Trustee under which the Debtor consented to the conversion of the case to Chapter 7. A Chapter 7 Trustee was appointed and obtained permission to employ the Debtor's bankruptcy counsel to continue prosecution of the adversary proceeding.

LSQ has alleged all along that the Chapter 11 case and adversary proceeding were filed at Millennium's behest, stating in its motion to dismiss the bankruptcy case that "Millennium has forced the Debtor to file this chapter 11 case for the sole purpose of facilitating its own recovery." *See In re Engstrom*, No. 20-22839-kmp, Docket No. 15 at 2-3. The Debtor and now the Chapter 7 Trustee have alleged that LSQ conspired with the Debtor to transfer worthless accounts to Millennium — "Although both the Debtor and LSQ knew that the accounts were worthless, that the Debtor was engaged in a fraudulent scheme, and that the Debtor's obligations to the new factor [Millennium] would only grow should the Debtor continue the scheme, they, in concert, cloaked the transaction in a veil of normalcy to ensure that LSQ was paid off." Trustee's Brief in Response to Summary Judgment Motion, Docket No. 62, p. 2.

Discussion

LSQ argues in its motion for summary judgment that the Trustee cannot establish an essential element of his case — that "any transfer of an interest of the debtor in property" occurred. That element is required to establish a preference under § 547 ("the trustee may . . . avoid any transfer of *an interest of the debtor in property* . . ."), a fraudulent transfer under § 548 ("the trustee may avoid any transfer . . . of *an interest of the debtor in property*"), or a claim under § 544(b) ("the trustee may avoid any transfer of *an interest of the debtor in property* . . ."). In "all but the most unusual situations, a single use of a statutory phrase must have a fixed meaning across a statute." *Lomax v. Ortiz-Marquez*, 140 S. Ct. 1721, 1725 (2020) (quoting *Cochise Consultancy, Inc. v. United States ex rel. Hunt*, 139 S. Ct. 1507, 1512 (2019)).

The Bankruptcy Code does not define "an interest of the debtor in property." The Supreme Court was asked to interpret the precursor to this statutory phrase, "property of the debtor," in *Begier v. I.R.S.*, 496 U.S. 53 (1990).[1] In that case, the Court defined the phrase as follows:

1. Congress amended § 547(b) in 1984 and substituted the current language of the statute, "an interest of the debtor in property," for the previous language of the statute, "property of the debtor." *Begier*, 496 U.S. at 59 n.3. The Supreme Court has read the older language and the current language as "coextensive with 'interests of the debtor in property' as that term is used in 11 U.S.C. § 541(a)(1)." *Id.*

> Because the purpose of the avoidance provision is to preserve the property includable within the bankruptcy estate — the property available for distribution to creditors — "property of the debtor" subject to the preferential transfer provision is best understood as that *property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings*.

Id. at 58 (emphasis added).

Generally speaking, a transfer by a debtor of borrowed funds constitutes a "transfer of an interest of the debtor in property." *In re Smith*, 966 F.2d 1527, 1533 (7th Cir. 1992) (citing *Smyth v. Kaufman*, 114 F.2d 40, 42 (2d Cir. 1940); *In re Bohlen Enters., Ltd.*, 859 F.2d 561, 567 (8th Cir. 1988); *Brown v. First Nat'l Bank*, 748 F.2d 490, 492 n.6 (8th Cir. 1984)). The Seventh Circuit has referred to the "earmarking doctrine" as an exception to that general rule. *Smith*, 966 F.2d at 1533. In every earmarking situation, there are three necessary parties: the "old creditor" (the pre-existing creditor who is paid off), the "new creditor" (the entity who supplies the funds to pay off the old creditor), and the debtor. *See Bohlen*, 859 F.2d at 565. "Courts applying [the earmarking doctrine] have reasoned that when a new lender makes a loan to a debtor to enable it to repay a specified former lender, the proceeds of that new loan do not become part of the debtor's estate, and thus there is no transfer of property in which the debtor has an interest." *In re Grabill Corp.*, 135 B.R. 101, 108-09 (Bankr. N.D. Ill. 1991) (citing *Bohlen*, 859 F.2d at 565; *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1356 (5th Cir. 1986); *In re Network 90°, Inc.*, 126 B.R. 990, 994 (N.D. Ill. 1991)). *See also In re Ljubic*, 362 B.R. 914, 918 (Bankr. E.D. Wis. 2007) ("[T]he earmarking doctrine states that when a third party lends money to the debtor for the specific purpose of paying off a designated creditor, that money is not 'an interest of the debtor in property,' so the transfer fails to satisfy one of the requirements of a preference under section 547(b)."). "If all that occurs in a 'transfer' is the substitution of one creditor for another, no preference is created because the debtor has not transferred property of his estate; he still owes the same sum to a creditor, only the identity of the creditor has changed. This type of transaction is referred to as 'earmarking' . . . ." *Coral Petroleum*, 797 F.2d at 1356; *see also In re Kenosha Liquidation Corp.*, 158 B.R. 774, 777 (Bankr. E.D. Wis. 1993).

"The [earmarking] doctrine is applicable only where a third party lends money to the debtor *for the specific purpose of paying a selected creditor*." *Smith*, 966 F.2d at 1533 (emphasis in original). "In such circumstances the payment is 'earmarked' and the third party simply substitutes itself for the original creditor. Such a transfer is said not to be a preferential transfer because (1) the debtor never exercises 'control' over the new funds; and (2) the debtor's property (i.e., the fund out of which creditors can be paid) is not diminished." *Id.; see also Coral Petroleum*, 797 F.2d at 1356 ("The earmarking doctrine is widely accepted in the bankruptcy courts as a valid defense against a preference claim, primarily because the assets from the third party were never in the control of the debtor and therefore payment of these assets to a creditor in no way diminishes the debtor's estate.").

The Eighth Circuit has summarized the origins of the earmarking doctrine as follows:

> The earliest enunciation of the doctrine occurred in cases where the new creditor providing new funds to pay off the old creditor, was himself also obligated to pay that prior debt. In other words, the new creditor was a guarantor of the debtor's obligation, such as a surety, a subsequent endorser or a straight contractual guarantor. Where such a guarantor paid the debtor's obligation directly to the old creditor, the courts rejected the claim that such payment was a voidable preference. *See e.g. National Bank of Newport v. National Herkimer County Bank*, 225 U.S. 178, 32 S. Ct. 633, 56 L. Ed. 1042 (1912). The holding rested on a finding that the new creditor's payment to the old creditor did not constitute a transfer of the debtor's property. The courts buttressed this conclusion with the rationale that no diminution of the debtor's estate had occurred since the new funds and new debt were equal to the preexisting debt and the amount available for general creditors thus remained the same as it was before the payment was made. A possible additional rationale may have been the view that such a result was needed to avoid unfairness and inequity to the new creditor. If his direct

> payment to the old creditor was voided, and the money was ordered placed in the bankruptcy estate, the new creditor, as guarantor, would have to pay a second time.

Bohlen, 859 F.2d at 565.

The courts then extended the doctrine to situations "[w]here the guarantor, instead of paying the old creditor directly, entrusted the new funds to the debtor with instructions to use them to pay the debtor's obligation to the old creditor." *Id.* (citing *First Nat'l Bank of Danville v. Phalen*, 62 F.2d 21 (7th Cir. 1932)). "Courts allowed the use of the doctrine in these instances even though the debtor had some control over the funds. The courts justified their results by stating that the debtor was holding the new funds 'in trust' or in a 'fiduciary capacity,' that they would not let 'form control over substance,' or that the result involved 'no diminution' of the debtor's estate." *Kenosha Liquidation Corp.*, 158 B.R. at 779 (citing *Bohlen*, 859 F.2d at 565-66). As noted by the Seventh Circuit,

> The law has regard for substance, rather than 'shades or shadows,' and the mere fact that the money, under the circumstances, was credited to the company, did not make it the funds of the company, and liable to be distributed among its creditors in the event of its being adjudicated a bankrupt.

Phalen, 62 F.2d at 23 (citation omitted).

Courts then extended the earmarking doctrine to non-guarantor situations, applying the doctrine "where the new creditor is not a guarantor but merely loans funds to the debtor for the purpose of enabling the debtor to pay the old creditor." *Bohlen*, 859 F.2d at 566; *see also Smith*, 966 F.2d at 1533. The Trustee notes that some courts have been critical of the extension of the doctrine to situations where a new creditor loans funds to the debtor to pay an old creditor. *See In re Neponset River Paper Co.*, 231 B.R. 829 (B.A.P. 1st Cir. 1999) (rejecting application of earmarking doctrine to non-guarantor situations, but then analyzing application of earmarking doctrine); *Bohlen*, 859 F.2d at 566 (criticizing application of earmarking doctrine to non-guarantor situations, but then analyzing application of earmarking doctrine). However, numerous other courts have reasoned that when a new creditor loans a debtor money so that the debtor can repay the particular debt of an old creditor, and the debtor does not exercise any "dispositive control" over the funds, the earmarking doctrine should be applied. *See, e.g. Coral Petroleum*, 797 F.2d at 1361-62; *Network 90°, Inc.*, 126 B.R. at 994; *Grabill*, 135 B.R. at 109-10.

Regardless of the criticism of the earmarking doctrine, the Seventh Circuit has not limited the earmarking doctrine to guarantor situations, noting that the "doctrine is applicable only where a third party lends money to the debtor *for the specific purpose of paying a selected creditor*," and this Court is bound to follow that precedent. *See Smith*, 966 F.2d at 1533 (emphasis in original); *see also Grabill*, 135 B.R. at 108-09 (rejecting trustee's argument that earmarking doctrine should only apply to "guarantors or sureties" and holding that the "earmarking doctrine may apply where funds are loaned or given to a debtor which are intended for a particular party.").

The Trustee acknowledges in this case the existence of an agreement between the new lender (Millennium) and the Debtor that the new funds would be used to pay the specified antecedent debt to LSQ and the performance of that agreement in accordance with its terms. Trustee's Response Brief, p. 21. The two questions requiring adjudication in this case are whether the Debtor exercised "control" over the transferred funds and whether the transaction resulted in "diminution of the estate." *Id.*

A key inquiry into whether a transfer to a third party, like LSQ, is voidable is the source of control over the new funds. Broadly speaking, application of the earmarking doctrine is based on a determination that no property in which the debtor had a beneficial interest was transferred. The ability of a debtor to exercise control over property indicates that it constitutes "an interest of the debtor in property." If a debtor does not exercise control over property, then this indicates that it is not "an interest of the debtor in property." *In re Superior Stamp & Coin Co.*, 223 F.3d 1004, 1008-09 (9th Cir. 2000) ("[S]ource of control over the new funds" is a "key inquiry" of the earmarking doctrine because "funds never become the debtor's property [if] they are not within the debtor's 'control'" and the debtor's estate is not diminished where there is no transfer of the debtor's property). If there is no "transfer of an interest of the debtor in property," then there can be no liability under 11 U.S.C. §§ 544, 547, or 548.

In discussing whether a debtor exercised "control" over the new funds in *Smith*, the Seventh Circuit found *Smyth v. Kaufman*, 114 F.2d 40 (2d Cir. 1940) instructive. In that case, the debtor was a jewelry and pawnbroking establishment. It owed money on a note, was sued in state court by the executors of the estate of the payee on the note, did not answer the complaint, but instead entered into a settlement agreement with the executors. At the time of the execution of the settlement agreement, the debtor delivered two checks to the executors. The first check in the amount of $723.76 was dated the same date as the settlement agreement. The second check was in the amount of $500.00 and was post-dated a week later. The executors presented the first check for $723.76 to the bank and it was returned for insufficient funds. The debtor then borrowed $500.00 from his landlord and paid it to the executors to cover the first check along with funds provided by the debtor. When the second check came due a week later, the debtor informed the executors that it did not have sufficient funds in its bank account to cover the $500.00 check and suggested instead that the executors present the check to his landlord and that his landlord would give the executors $500.00.

A few weeks later, an involuntary bankruptcy petition was filed against the debtor and the trustee sued the executors to recover the payments as preferences. The executors argued that the payments could not be recovered because the payments were made by the landlord from funds that were never part of the debtor's assets. The Second Circuit rejected this argument, holding that the debtor's payments with money borrowed from its landlord was a preferential transfer recoverable by the trustee under the Bankruptcy Act.

In reaching this decision as to the first check, the Second Circuit stated, "We can discover nothing indicating that [the landlord] loaned this $500 on condition that it should be applied to this particular creditor. While [the landlord] apparently knew that it would be used for this purpose, so far as we can see he made the loan generally." *Id.* at 42. Therefore, "the payment was not protected under the doctrine of those cases holding that a creditor who receives payment from a surety of the bankrupt, or from one who lends to the bankrupt only for the specific purpose of paying a certain creditor, has not received a voidable preference, and it seems clear that the payment of the first check for $723.76 was an unlawful preference." *Id.*

As to the second check, the Second Circuit could see no essential difference between the two payments, even though the money used to pay the second check came directly from the landlord and never passed through the hands of the debtor. The court believed that the only interest the landlord had in lending money to the debtor was to keep the debtor in business so that its lease would continue and its rent would be paid. There was "no evidence that [the landlord] conditioned this [second] loan, any more than the first one, upon the payment of any particular creditor or that he cared who was paid." *Id.* The court found that:

> the arrangement was such that [the debtor] rather than [the landlord] designated the

> creditor to be paid and controlled the application of the loan which it secured from its landlord. The existence of this control determines whether the payments were preferential transfers by the bankrupt or were payments by a third party who did not make the loans generally but made them only on condition that a particular creditor receive the proceeds. The transfer here was not of special funds designated as such by the lender which could never have become generally available to all of the creditors.

Id. Because the loans from the landlord to the debtor were "unconditional," the proceeds became "part of the bankrupt's free assets" and the use of the loan from the landlord to extinguish the indebtedness to the executors constituted a preferential transfer. *Id.* at 43.

The Seventh Circuit relied on *Smyth* in determining that a debtor exercised significant control over funds that the debtor paid to a creditor from a provisional credit granted to the debtor by a bank, which credited the debtor's checking account for a $125,000 check that subsequently did not clear. *Smith*, 966 F.2d at 1534. In finding that the debtor had an interest in property, the court noted that for five days the debtor had $125,000 credited to his account and that "[b]y itself, such provisional credit might not evidence an interest of the debtor in property; but the debtor exercised dominion and control over the funds by making actual payment to a creditor." *Id.* at 1531. Instead of writing a check to the creditor, the debtor "could have written several checks, paying off each of its creditors on a pro rata basis." *Id.* Alternatively, the debtor "could have purchased a 40-foot yacht." *Id.* The loan from the bank "was *not* conditioned on [the creditor] being paid off" and the debtor exercised "significant control (over a significant amount of money) in choosing to pay off a single creditor." *Id.* at 1531, 1533. As in *Smyth*, "it was the debtor who exercised control over the funds and directed payment to one creditor over others." *Id.* at 1534. The debtor's control over the funds in its account ultimately resulted in the court holding that the debtor's transfer to the creditor was a "transfer of an interest of the debtor in property" avoidable under 11 U.S.C. § 547(b). *Id.* at 1537.

In summary, if a creditor makes a general loan and does not condition it upon a particular creditor receiving the proceeds and the funds could have become generally available to all creditors of the debtor, the debtor exercises control over those funds, the transfer is a "transfer of an interest of the debtor in property," the earmarking doctrine does not apply, and the loan is subject to the trustee's avoidance powers. *In re Flanagan*, 503 F.3d 171, 185 (2d Cir. 2007) ("where a new creditor provides funds to the debtor with no specific requirement as to their use, the funds do become part of the estate and any transfer of the funds out of the estate is potentially subject to trustee's avoidance powers."); *Superior Stamp*, 223 F.3d at 1009 ("If the debtor controls the disposition of the funds and designates the creditor to whom the monies will be paid independent of a third party whose funds are being used in . . . payment of the debt, then the payments made by the debtor to the creditor constitute a preferential transfer."); *Smith*, 966 F.2d at 1531 (where bank extended provisional credit to debtor, debtor has an interest in property because debtor had the right to disburse funds without limitation).

By contrast, if the creditor does not make a general loan and conditions the loan upon the payment of a particular creditor and the funds could have never become generally available to all creditors, the debtor does not exercise control over those funds, the transfer is not a "transfer of an interest of the debtor in property," and the earmarking doctrine applies such that there is no liability under 11 U.S.C. § 544, 547, or 548. *See Flanagan*, 503 F.3d at 185 ("The proper application of the earmarking doctrine depends not on whether the debtor temporarily obtains possession of new loan funds, but instead on whether the debtor is obligated to use those funds to pay an antecedent debt."); *Superior Stamp*, 223 F.3d at 1009 ("the proper inquiry is . . . whether the debtor had the right to disburse the funds to whomever it wished, or whether their disbursement was limited to a particular old creditor or creditors under the agreement with the new creditor."); *In re Montgomery*, 983 F.2d 1389, 1395 (6th Cir. 1993) ("where the borrowed funds have been specifically earmarked by the lender for payment to a designated creditor, there is held to be no transfer of property of the debtor even if the funds pass through the debtor's hands in getting to the selected creditor."); *In re Hartley*, 825 F.2d 1067, 1070 (6th Cir. 1987) ("When a third person loans money to a debtor specifically to enable him to satisfy the claim of a designated creditor, the general rule is that the proceeds are not the property of the debtor, and therefore the transfer of the proceeds to the creditor is not preferential."); *Network 90°*, 126 B.R. at 994 ("The foundation of the earmarking doctrine lies not in the relationship of the old and new creditors and the debtor, but in the debtor's control (or lack of control) over the assets which were transferred."); *Grubb v. Gen. Contract Purchase Corp.*, 94 F.2d 70, 73 (2d Cir. 1938) (L. Hand, J.) (where a debtor receives funds subject to a clear obligation to use that money to pay off a preexisting debt, and the funds are in fact used for that purpose, those funds do not become part of the estate and the transfer cannot be avoided in bankruptcy).

The first issue that this Court needs to decide in determining whether the earmarking doctrine applies is whether the Debtor had "control" over the funds transferred from Millennium to LSQ. Based upon the undisputed facts before the Court on this motion for summary judgment, the Court finds that the Debtor did not have control over the funds transferred from Millennium to LSQ.

The undisputed facts in this case show that:

- The Debtor and Millennium agreed that Millennium would advance funds solely for the purpose of satisfying LSQ's debt. (Statement of Facts ¶ 22.)

- The $10,306,661.56 that Millennium remitted directly to LSQ on January 29, 2020 represented a loan from Millennium to the Debtor. (Statement of Facts ¶ 20.)

- The wire transfer of $10,306,661.56 originated entirely from an account owned or controlled by Millennium. (Statement of Facts ¶ 17.)

- The wire transfer of $10,306,661.56 did not originate from any account owned or controlled by the Debtor. (Statement of Facts ¶¶ 18 & 19.)

- The Debtor had no ability or discretion to transfer the $10,306,661.56 wire transfer to any person or entity other than LSQ. (Statement of Facts ¶ 23.)

Importantly, the Debtor admitted in its responses to requests for admissions that it had no discretion to transfer the funds LSQ received on January 29, 2020 to any person or entity other than LSQ:

> *REQUEST TO ADMIT NO. 12*: Admit that the Debtor had no discretion to transfer the funds that LSQ received on January 29, 2020 to any person or entity other than LSQ.
>
> SUPPLEMENTAL RESPONSE: Subject to the general objections stated in the Plaintiff's Response to LSQ Funding Group, L.C.'s First Set of Requests for Admission, First Set of

> Interrogatories, and First Set of Requests for Production to Plaintiff, and without waiving such objections, the Debtor admits this request.

Wronski Dec., ¶ 4, Ex. C. The Debtor further conceded in its interrogatory responses that the Debtor did not have discretion to transfer the funds LSQ received on January 29, 2020 to another person or entity.

> *INTERROGATORY NO. 17*: If you contend that the Debtor had discretion to transfer the funds that LSQ received on January 29, 2020 to a person or entity other than LSQ, state the complete factual basis for your contention.
>
> RESPONSE: Subject to the general objections stated in the Plaintiff's Response to LSQ Funding Group, L.C.'s First Set of Requests for Admission, First Set of Interrogatories, and First Set of Requests for Production to Plaintiff, and without waiving such objections, the Debtor did not have discretion to transfer the funds that LSQ received on January 29, 2020 to another person or entity.

The Trustee has not presented any facts to refute this evidence or to show that there is a genuine issue for trial related to the Debtor's lack of dominion or control over the funds wired by Millennium to LSQ to satisfy the debt owed by the Debtor to LSQ. Instead, the undisputed facts show that Millennium did not make a general loan. Millennium conditioned its loan on the payment of a particular creditor, namely LSQ. The Debtor never had any access to any of the funds transmitted by Millennium to LSQ. None of the funds passed through the Debtor's accounts. The Debtor never exercised dominion or control over the funds transmitted by Millennium to LSQ. The Debtor did not have the right to disburse the funds to whomever it wished. The Debtor had no ability to write checks to other creditors out of the proceeds sent from Millennium to LSQ. The Debtor had no ability to acquire other assets with the proceeds of the loan instead of paying LSQ. The Debtor had no ability to purchase a 40-foot yacht with the proceeds from Millennium to LSQ. The loan from Millennium was entirely conditioned on LSQ being paid off. These facts irrefutably establish that the funds that Millennium wired directly to LSQ were earmarked and outside of the Debtor's dominion or control. As a result, these funds never constituted "an interest of the Debtor in property."

The Trustee concedes that the Debtor did not physically control the funds. Trustee's Response Brief, p. 21. The Trustee then argues that the *Smith* case does not require a debtor to physically control the funds and that the Debtor has the requisite control over the funds "when such payment represents a loan by the third party to the debtor and the debtor, rather than the lender, designates the creditor to be paid and controls the application of the loan." *Smith*, 966 F.2d at 1533 (citation omitted). Thus, according to the Trustee, a debtor can "exercise control by selecting and paying off a single creditor." *Id.* The Trustee argues that in this case the Debtor controlled the funds because it "designated LSQ as the appropriate party to receive the funds, and directed Millennium to disburse funds directly to pay LSQ in full." Trustee's Response Brief, p. 21.

The problem with the Trustee's argument is that it ignores the Seventh Circuit's broader acknowledgement that the earmarking doctrine applies "where a third party lends money to the debtor *for the specific purpose of paying a selected creditor*." *Smith*, 966 F.2d at 1533 (emphasis in original). The Trustee's argument further ignores the fact that in declining to apply the earmarking doctrine and finding that the debtor exercised control over the funds in its bank account, the *Smith* court found it critical that the loan "was *not* conditioned on [the creditor] being paid off." *Id.* at 1533. Following *Smith*, a debtor does not have "control" over borrowed funds if the loan is conditioned on the payment of a particular creditor. This lack of control shows that there has been no transfer of an interest of the debtor in the funds.

Other courts have rejected outright the Trustee's argument that a debtor can "control" borrowed funds merely by designating the recipient of the payment:

> It is irrelevant whether the debtor or the lender initiates discussions concerning a loan or proposes a particular creditor as the recipient of the funds, so long as the funds are advanced on the condition that they be used to pay that specific creditor. Where there is an agreement between a new lender and the debtor that the funds will be used to pay a specified antecedent

> debt, a debtor has not exercised control over the funds by 'designat[ing] the creditor to whom the monies will be paid . . .'

Superior Stamp, 223 F.3d at 1010.

Here, Millennium conditioned its loan to the Debtor on the proceeds being used to pay off the debt owed by the Debtor to LSQ. *See* Statement of Facts No. 22. The Debtor has admitted "that the Debtor and Millennium had an agreement whereby the funds that Millennium sent to LSQ by wire transfer in the amount of $10,306,661.56 on January 29, 2020 would be used to pay the debt that the Debtor owed to LSQ." *See id.*; Wronski Dec. ¶ 3, Ex. B, Req. to Admit No. 9. The Debtor has further admitted that it "had no discretion to transfer the funds that LSQ received on January 29, 2020 to any person or entity other than LSQ." *See* Statement of Facts No. 23, Wronski Dec ¶ 4, Ex. C, Req. to Admit No. 12. As admitted by the Debtor in its interrogatory responses, "the Debtor did not have discretion to transfer the funds that LSQ received on January 29, 2020 to another person or entity." *Id.*, Interrogatory No. 17. The Debtor did not have control over the borrowed funds in this case because Millennium conditioned its loan to the Debtor on the payment of LSQ.

The Trustee argues that the Court should not apply the earmarking doctrine here because LSQ has "unclean hands." The Trustee charges that the debt owed to LSQ, and then Millennium after the Debtor borrowed funds to pay off LSQ, was the result of an elaborate fraud perpetrated by Cherie Campion, the Debtor's chief executive officer, and that LSQ was aware of the fraud. Because the earmarking doctrine is at its heart an equitable doctrine, the Trustee requests that the Court not afford equitable relief to LSQ, a party that has acted "inequitably."

The problem with the Trustee's argument is that there is no corollary to the earmarking doctrine that precludes its application in cases involving fraud. In its analysis of the earmarking doctrine, the Court is engaging in the inquiry of whether the transaction constituted a "transfer of an interest of the debtor in property" as that language is used in § 544, § 547, and § 548. The earmarking doctrine provides that the transfer of a third party's property to a creditor for the purpose of paying that creditor's debt is not avoidable as either a preference or a fraudulent transfer because the debtor has no interest in such property. In determining whether the earmarking doctrine applies, the Court examines the debtor's control over the new funds and whether the debtor's property has diminished. *Smith*, 966 F.2d at 1533. Where the debtor never exercises control over the new funds and where the debtor's property is not diminished, the earmarking doctrine applies, and courts find that there has been no transfer of an interest of the debtor in property and dismiss avoidance actions brought under 11 U.S.C. §§ 544, 547, or 548.

The fact that borrowed funds were allegedly obtained by fraud does not affect this analysis. In *Smith*, for example, the Seventh Circuit conducted its review of the earmarking doctrine, specifically focusing on whether the debtor controlled borrowed funds, notwithstanding the fact that the transaction involved fraud in the form of the debtor's check-kiting scheme. *Id.* at 1534. The Court is unaware of any cases where "equitable" principles have been applied to deny the application of the earmarking doctrine where a trustee is unable to satisfy his burden of showing that there has been a transfer of the debtor's interest in property, nor has the Trustee cited to any. The Court rejects the Trustee's request to apply equitable principles over the express language of the statute that requires the Trustee to prove that there has been a "transfer of the Debtor's interest in property."

The second issue in dispute in this case is whether the transaction between the old creditor, LSQ, the Debtor, and the new creditor, Millennium, resulted in "diminution of the debtor's estate." Put another way, did Millennium's payoff of the $10 million factoring agreement that the Debtor had with LSQ result in a diminution of the Debtor's estate? The transaction is voidable only to the extent the transaction depleted the debtor's estate.

The Bankruptcy Code does not contain an explicit diminution of the estate requirement. Nevertheless, courts have "long held that to be avoidable, transfers must result in a depletion or diminution of the debtor's estate." *Smith*, 966 F.2d at 1535; *see also Warsco v. Preferred Tech. Grp.*, 258 F.3d 557, 564 n.11 (7th Cir. 2001) ("We have recognized in the past that diminution of the debtor's estate is not an element of the preference statute. However, we also have recognized that 'the "diminished estate" element of a preferential transfer is consistently applied,' and we previously have refused to disturb its application.

In keeping with our prior precedent and that of other circuits, we continue to consider whether the transfer in question diminished the debtor's estate."). Thus, the Seventh Circuit requires a plaintiff in an avoidance action to prove that the transfer resulted in diminution of the debtor's bankruptcy estate.

"This requirement is normally considered part of the search for a transfer of the debtor's interest in property." *Smith*, 966 F.2d at 1535-36. Whether a transfer is of an interest of the debtor in property depends on whether the transfer "will deprive the bankruptcy estate of something which could otherwise be used to satisfy the claims of creditors." *In re Merchant Grain, Inc.*, 93 F.3d 1347, 1352 (7th Cir. 1996). This requirement echoes the Supreme Court's recognition in *Begier* that "if the debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the policy behind the avoidance power is not implicated." *Begier*, 496 U.S. at 58. If the earmarking doctrine applies, the transaction simply involves a new creditor using its own funds to step into the shoes of the old creditor with no net impact on the estate. "The use of earmarked funds to pay an existing creditor simply results in a new debt replacing an old debt, and the fund available for debtor's general creditors remains unchanged." *Neponset River*, 231 B.R. at 835 (citing *Bohlen*, 859 F.2d at 565); *see also Kenosha Liquidation*, 158 B.R. at 781 ("This substitution of creditors has neither improved nor impaired the situation for the other unsecured creditors."). When a third party makes a transfer for the debtor's benefit, no avoidable transfer results because the third party's property would not have become an estate asset or been available to the debtor's creditors.

A transfer is not avoidable unless it "diminish[es] directly or indirectly the fund to which creditors of the same class can legally resort for the payment of their debts, to such an extent that it is impossible for other creditors of the same class to obtain as great a percentage as the favored one." *In re Kemp Pacific Fisheries, Inc.*, 16 F.3d 313, 316 (9th Cir. 1994). *See also Neponset River*, 231 B.R. at 835 ("Diminution of the estate occurs where the transfer reduces the pool of funds available to all, so that creditors in the same class do not receive as great a percentage as the preferred creditor"); *Hartley*, 825 F.2d at 1070 ("If the transfer diminishes the estate, the other creditors are injured because less remains for them to share"); *Brown*, 748 F.2d at 491 (affirming dismissal of Trustee's avoidance claims, finding no diminution of the debtor's estate where funds were not property of the debtor such that the "funds available for distribution to the other creditors was not reduced"). *See also In re Art Unlimited, LLC*, No. 07-C-54, 2007 WL 2670307, at *9 (E.D. Wis. Sept. 6, 2007) (affirming dismissal of fraudulent transfer claim where "[n]one of the assets would have been available to unsecured creditors in a subsequent liquidation, that is, they would not have been part of the bankruptcy estate."); *Ljubic*, 362 B.R. at 918 ("the inquiry under the earmarking doctrine is whether an asset would have been available for distribution to all creditors but for its transfer to the recipient."); *In re Moeri*, 300 B.R. 326, 329 (Bankr. E.D. Wis. 2003) ("Under the earmarking doctrine, there is no avoidable preferential transfer of debtor's property interest when the new lender and the debtor agree to use loan funds to pay a specified antecedent debt and where the agreement's terms are actually performed and the transaction, viewed as a whole, does not diminish the debtor's estate.").

The Seventh Circuit addressed the diminution of the estate requirement in the *Smith* case. By way of background, in that case, the Seventh Circuit was faced with a Chapter 7 debtor's payment to a creditor by check, achieved through a provisional credit granted to the debtor by a bank, which credited the debtor's checking account for a $125,000 check that subsequently did not clear. The Chapter 7 trustee brought an adversary proceeding seeking to avoid the $125,000 payment to the creditor as a preferential transfer. The creditor argued that there was no diminution of the estate because the money it received never would have been available for bankruptcy distribution because the debtor's credit was revoked within five days of payment, the debtor only had a provisional credit of $125,000 in its bank account, the debtor never really had more than $164 in its bank account, and the debtor's account had shrunk back down to $164 — all before the bankruptcy petition was filed.

The Seventh Circuit rejected the creditor's argument and held that the debtor's estate was diminished by the transfer. The court noted that there are two ways that the case law looks at the diminution of the estate requirement. Under the first, stricter approach, the diminution of the estate requirement means that "the pool available to creditors at the commencement of the case has been depleted from what it would have been but for the transfer; in other words, the estate as it exists at the commencement of the case is compared to what the estate would have included if there had been no transfer." *Smith*, 966 F.2d at 1536. The creditor, of course, argued that because the debtor had $164 at the beginning of the case and the $125,000 provisional credit was not available for bankruptcy distribution and not part of the estate, there was no diminution of the estate. Under the second, broader approach, the court noted that the diminution of the estate requirement could be "interpreted more broadly to include diminishing the pool available to creditors at any time after the start of the 90-day preference period; then the debtor's pre-transfer property (that could be used to pay creditors) would simply be compared to its post-transfer property." *Id.*

In concluding that the debtor's estate was diminished by the transfer, the Seventh Circuit focused on the "control" the debtor had over the $125,000 provisional credit in its account for five days. The court noted that "the estate may have been larger 'but for' the transfer to [the creditor]." *Id.* at 1536. The debtor could have "written several checks, paying off each of its creditors on a pro rata basis." *Id.* at 1531. Alternatively, the debtor "could have purchased a 40-foot yacht" or "acquired some other assets instead of paying his debt to [the creditor]; so his assets at the time the petition was filed could have been more substantial than they actually were." *Id.* at 1531, 1536-37. "The point is that the debtor exercised significant control (over a significant amount of money) in choosing to pay off a single creditor." *Id.* at 1531. Additionally, the court did not think that "a strict construction of the 'estate diminution' requirement should defeat recovery in the circumstances of this case." *Id.* at 1537.

Importantly, the Seventh Circuit stated that "[w]hen a debtor effectively borrows *nonearmarked* funds and exercises control by using the funds to pay a preferred creditor over others, the estate has been diminished." *Id.* at 1537 (emphasis added). The term "nonearmarked" is critically important in the Seventh Circuit's holding. If a debtor borrows "earmarked" funds (i.e. borrowed funds specifically earmarked by a lender for payment to a designated creditor) and the debtor does not exercise control over the new funds and the debtor's property (i.e. the fund out of which creditors can be paid) is not diminished, there is no transfer of an interest of the debtor in property. *See id.* at 1533.

The second issue that this Court needs to decide in determining whether the earmarking doctrine applies is whether the transaction between the old creditor, LSQ, the Debtor, and the new creditor, Millennium, resulted in "diminution of the debtor's estate." Based upon the undisputed facts before the Court on this motion for summary judgment, the Court finds that there was no diminution of the estate; therefore, the earmarking doctrine applies and there has been no transfer of an interest of the Debtor in property.

The undisputed facts in this case show that:

- Immediately before LSQ's receipt of the wire transfer of $10,306,661.56 on January

29, 2020, the Debtor was indebted to LSQ in an amount equal to $10,306,661.56. (Statement of Facts ¶ 25.)

- Immediately after LSQ's receipt of the wire transfer, the Debtor was no longer indebted to LSQ in any amount. (Statement of Facts ¶ 26.)

- Immediately after Millennium's initiation of the $10,306,661.56 wire transfer to LSQ, the Debtor was indebted to Millennium in the same amount. (Statement of Facts ¶ 27.)

- As discussed previously, the Debtor had no ability or discretion to transfer the $10,306,661.56 wire transfer to any person or entity other than LSQ. (Statement of Facts ¶ 23.)

- The collateral in which Millennium received a security interest from the Debtor to secure repayment of the $10,306,661.56 remitted to LSQ was the same collateral that secured repayment of the Debtor's obligations to LSQ before LSQ's receipt of the $10,306,661.56 wire transfer from Millennium. (Statement of Facts ¶ 21.)

These facts demonstrate that Millennium's payoff of the $10 million factoring agreement that the Debtor had with LSQ did not result in a diminution of the Debtor's estate. Before the wire transfer, the Debtor owed LSQ $10,306,661.56 and had granted it a security interest in its accounts. After the wire transfer, the Debtor owed Millennium the same amount, $10,306,661.56 and had granted it a security interest in the same collateral. The transaction simply involved Millennium, as the new creditor, using its funds to step into the shoes of LSQ, as the old creditor, with no net impact on the estate. The new loan with Millennium did not deprive the Debtor's bankruptcy estate of something that could otherwise be used to satisfy the claims of its other creditors. The proceeds of this loan were not available for distribution to the Debtor's creditors. The Debtor had no ability or discretion to transfer the $10,306,661.56 wire transfer to any person or entity other than LSQ. Millennium was simply substituted for LSQ with respect to the debt the Debtor previously owed to LSQ. Had the transfer not been made, the Debtor's assets and total obligations would have remained exactly the same — only the identity of the Debtor's primary creditor would have changed.

Unlike the debtor in *Smith*, the Debtor in this case did not have access to or control over the $10,306,661.56 wired by Millennium to LSQ. None of the funds passed through the Debtor's bank account. LSQ received a wire transfer directly from Millennium, and the funds did not originate from any account owned or controlled by the Debtor. There was no five-day period in which the Debtor had access to the funds to spend as it pleased. The Debtor did not have the right to disburse the funds to whomever it wished. The Debtor had no ability to write checks to other creditors out of the proceeds sent from Millennium to LSQ. The Debtor had no ability to acquire other assets with the proceeds of the loan instead of paying LSQ. The Debtor had no ability to purchase a 40-foot yacht with the proceeds sent from Millennium to LSQ. The Debtor had no discretion to transfer the funds that LSQ received on January 29, 2020 to any person or entity other than LSQ. The loan from Millennium was entirely conditioned on LSQ being paid off. The Debtor's estate would not have been larger but for the transfer to LSQ. The Debtor borrowed funds that were specifically earmarked by Millennium for payment of LSQ, the Debtor did not exercise control over those funds, and Millennium's payoff of the $10 million factoring agreement that the Debtor had with LSQ did not result in depletion or diminution of the Debtor's estate. As a result, there has been no transfer of a debtor's interest in property, so the transfer of funds from Millennium to LSQ is not avoidable.

The Trustee points to three ways in which he believes the Debtor's estate was diminished when the Debtor entered into the Millennium Agreement. Trustee's Response Brief, p. 24 (Docket No. 62). All relate to alleged higher factoring fees imposed in the Millennium Agreement versus the LSQ Invoice Purchase Agreement. One of LSQ's affiants described the factoring relationship set forth in the LSQ Agreement as follows:

> The Debtor would issue invoices to its customers for temporary staffing services. The Debtor would submit those invoices to LSQ for purchase. . . . Upon acceptance, LSQ would advance the Debtor approximately 85% of the

> face amount of the purchased invoices. Once LSQ received payment from the Debtor's customer on a purchased invoice, the Debtor could request that LSQ send the Debtor the remainder of the face amount of the paid invoice, less the amounts owed to LSQ under the IPA.

Bailey Dec., ¶ 7. Likewise, one of Millennium's affiants described the factoring relationship set forth in the Millennium Agreement as follows:

> The Millennium Agreement was designed to operate like a standard factoring agreement: once the Debtor submitted invoices to its customers and Millennium, Millennium would advance 85% of the face value of the invoices to the Debtor. After Millennium received payment directly from the Debtor's customers, it would advance the remaining 15%, less any fees set forth in the contract.

Benkovich Dec., ¶ 15.

To support his argument that the Debtor's estate was diminished when the Debtor entered into the Millennium Agreement, the Trustee first argues that the Debtor's agreement with Millennium required the Debtor to pay a higher based factoring fee than its agreement with LSQ previously did. The Trustee points the Court generally to the LSQ Agreement and the Millennium Agreement in support of this argument. Bailey Dec.,

¶ 6, Ex. A; Benkovich Dec., ¶ 14, Ex. A. The Trustee offers no explanation based upon the terms of either Agreement to support his conclusion that the factoring fee is higher in the Millennium Agreement than it was in the LSQ Agreement. The Court has no evidence before it to conclude one way or the other whether the factoring fees are indeed higher in the Millennium Agreement. The Court is not obligated to wade through the factoring agreements to make this determination on its own. *See Carter v. Am. Oil Co.*, 139 F.3d 1158, 1163 (7th Cir. 1998) ("Neither the district court nor this Court is obligated in considering a motion for summary judgment to assume the truth of a nonmovant's conclusory allegations on faith or to scour the record to unearth material factual disputes."). The Trustee carries the burden of proving that the transfer from Millennium to LSQ resulted in a diminution of the estate. The Trustee's first argument fails because there is no evidentiary support for this argument.

The Trustee next argues that the Debtor's estate was diminished because of the "concentration factoring fee" and the "second factoring fee" in the Millennium Agreement. The Millennium Agreement required "the Debtor to pay a concentration factoring fee for each account exceeding 40% of the total outstanding value of the Debtor's invoices" in contrast to the LSQ agreement, which did not contain a concentration factoring fee.[2]

2. It is debatable whether Millennium is actually charging the "concentration fee" to the Debtor. Although the factoring agreement with Millennium required the Debtor to pay a concentration fee, Millennium represented to the Court that it agreed to temporarily waive the provisions of the agreement providing for a higher fee

Benkovich Dec. at ¶ 16. Furthermore, the payoff sum of $10,306,661.56 included LSQ's factoring fee. *Id.* at ¶ 23. The Trustee asserts that the fees assessed under the Millennium Agreement constitute a "second factoring fee" thereby further diminishing the Debtor's estate. *Id.*

The crux of the Trustee's argument is that the higher factoring fees, the concentration factoring fee, and the second factoring fee all reduced the value of the Debtor's accounts receivable and reduced the pool of funds available to the Debtor's creditors, thereby resulting in diminution of the Debtor's estate.

Comparing the Debtor's pre-transfer property to its post-transfer property, none of these fees diminished the pool of assets available to creditors. Before the wire transfer, the Debtor owed LSQ $10,306,661.56, secured by all of the Debtor's accounts. After the wire transfer, the Debtor owed Millennium the same amount, and the same accounts secured the obligation. This shows that the transaction simply involved Millennium using its own funds to step into the shoes of LSQ with no net impact on the estate. The funds available for the Debtor's general creditors remained unchanged. The transfer of the collateral did not change the pool of assets available to creditors of the same class in any way. The accounts were not available for distribution to unsecured creditors in a liquidation, regardless of who the secured party was. The Debtor's estate was not diminished.

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and reserve percentage for concentration accounts, as defined in the agreement, and a $5,000 minimum factoring fee. *See In re Engstrom, Inc.*, No. 20-22839-kmp, Docket No. 132 at ¶ 23(a) n.2.

If the Millennium Agreement required the Debtor to pay higher fees than the LSQ Agreement, the Debtor simply had a better deal with LSQ than it had under the new agreement with Millennium. The Trustee fails to cite any authority for the proposition that a debtor's estate is diminished because its loan from a new creditor is on different, less favorable terms than the debt being paid off.

Finally, it is hard to see how the Debtor's estate was diminished when the Trustee takes the position that the accounts receivable were "substantially worthless," "fake," or "worthless." Trustee's Response Brief, p. 1, 2, 16 (citing Declaration of Paul G. Swanson, ¶ 44, Ex. NN) (Docket No. 62). If the accounts receivable were "substantially worthless," "fake," or "worthless," the imposition of additional factoring fees could not diminish the value of the Debtor's accounts receivable. Because there was no diminution of the Debtor's estate, the earmarking doctrine applies and there has been no transfer of an interest of the debtor in property.

It is an inescapable fact that most of the case law on the earmarking doctrine arises in the context of preference claims under 11 U.S.C. § 547(b). The Trustee acknowledges that a select number of courts have applied the earmarking doctrine to fraudulent transfer claims. The Trustee goes on to cite several decisions from bankruptcy courts in Illinois in support of his claim that no court in the Seventh Circuit has applied the earmarking doctrine to fraudulent transfer cases, but those cases are not at all helpful with the analysis nor do they support the Trustee's claim that no court in the Seventh Circuit has applied the earmarking doctrine to fraudulent transfer claims.

The first case quoted by the Trustee offers this: "Sometimes referred to as a nonstatutory defense to a preference avoidance action, the earmarking doctrine is a common law doctrine that has developed in the context of preference cases under section 547, not fraudulent transfer cases." *In re Grube*, 2011 WL 4704227, at *2 (Bankr. C.D. Ill. Oct. 6, 2011). The *Grube* court then goes on to describe how the earmarking doctrine applies to borrowed funds, how the debtor cannot have control of the funds, how the transaction must result in the substitution of one creditor for another, and how there must be no diminution of the estate. The court then rejects the application of the earmarking doctrine to a fraudulent transfer claim, not because it is a fraudulent transfer claim, but because the funds transferred in that case were not borrowed funds, there was no substitution of creditors, and the transfer did diminish the debtor's estate. If anything, it seems like the *Grube* court did analyze whether the earmarking doctrine applied to a fraudulent transfer claim, but it just did not apply to the specific facts of that case.

The Trustee notes in his second case that the court considered the earmarking doctrine only in regard to a preference claim and not a fraudulent transfer claim. *See In re Elite Mktg. Enters., Inc.*, 2001 WL 1669229, at *2 (Bankr. N.D. Ill. Dec. 13, 2001). This is true, but that court was deciding a motion to dismiss and found that it could not "determine based on the allegations of the complaint alone whether the debtor lacked any control over the funds or whether the estate was diminished by the transaction." It is unclear from the decision whether the bank sought dismissal of the fraudulent transfer claim based on the earmarking doctrine. It is equally unclear why the court would have to analyze the earmarking doctrine as part of its discussion of the fraudulent transfer claim when the court had already rejected the application of the earmarking doctrine based on the facts asserted in the complaint. The court's holding seems to simply be that it could not apply the earmarking doctrine as a matter of law based upon the facts presented in the complaint. This case also does not help this court determine whether the earmarking doctrine applies to a fraudulent transfer claim.

Finally, the Trustee offers the following quotation from *In re Doctors Hospital of Hyde Park*, 360 B.R. 787, 842 (Bankr. N.D. Ill. 2007): "At least one court has questioned whether the earmarking doctrine applies outside of a preference context." The *Doctors* court cited to *In re Eerie World Entertainment*, 2006 WL 1288578, at *6-7 (Bankr. S.D.N.Y. April 28, 2006) for its support for this statement. In looking at the *Eerie* decision, however, the court analyzed a creditor's claim that the earmarking doctrine provided him with an absolute defense to a fraudulent transfer claim. The court noted that "the key to the earmarking defense is the question of control." *Id.* at *6. The court assumed *arguendo* that "the earmarking doctrine can be imported from preference law into fraudulent conveyance cases in general" but found inadequate support for the proposition that the debtor did not have control over the funds. *Id.* Likewise, the *Doctors* court rejected the application of the earmarking doctrine to a fraudulent transfer claim, not because the earmarking doctrine does not apply to fraudulent transfer claims, but because the debtor exercised control over the transfer. *Doctors*, 360 B.R. at 842. Neither of these cases support the Trustee's position that the earmarking doctrine should not be applied to fraudulent transfer claims, and in fact show that courts are analyzing the earmarking doctrine as part of fraudulent transfer claims.

Despite the Trustee's contentions to the contrary, this Court is not breaking new ground by applying the earmarking doctrine to fraudulent transfer claims. *See Montoya v. Goldstein (In re Chuza Oil Co.)*, 2021 WL 3025608, at *5 (Bankr. D.N.M. July 16, 2021) (". . . at least in the case of co-debtors, the earmarking doctrine is a valid concept in fraudulent transfer actions. Because the transfers in question were made from 'earmarked' funds, they were not transfers of debtor's property, so § 548(a)(1) does not apply."); *Scott v. SunTrust Bank, N.A. (In re Dandridge)*, 616 B.R. 67, 2020 WL 2614615, at *1 (Bankr. W.D. Va. Jan. 31 2020) (granting summary judgment to previous lender after applying earmarking doctrine to § 544 fraudulent transfer claims where subsequent lender conditioned loan upon payout of previous lender and where debtor did not acquire option to direct or assign loan proceeds elsewhere); *Sherman v. TBK Bank, SSB (In re Dependable Auto Shippers, Inc.)*, 2018 WL 4348049, at *7 (Bankr. N.D. Tex. Sept. 7, 2018) ("The earmarking doctrine is a judicially created defense to this statutory requirement that a voidable preference or fraudulent conveyance include a transfer of an interest of the debtor in property."); *Cooper v. Centar Invs. (Asia) Ltd. (In re TriGem Am. Corp.)*, 431 B.R. 855, 869 (Bankr. C.D. Cal. 2010) ("the court is persuaded that earmarking has a role to play in fraudulent transfers as well as preference actions”); *Kapila v. Espirito Santo Bank (In re Bankest Capital Corp.)*, 374 B.R. 333 (Bankr. S.D. Fla. 2007) (granting summary judgment to trustee on § 544 fraudulent transfer claim where debtor had dominion and control over subject funds and there was no evidence of earmarking agreement); *In re Sanders*, 168 F.3d 490, 1998 WL 808373, at *2-3 (6th Cir. 1998) (unpublished table decision) (analyzing application of earmarking doctrine to fraudulent transfer claim, but finding transfer to be an interest of the debtor in property); *In re Art Unlimited, LLC*, No. 07-C-54, 2007 WL 2670307 (E.D. Wis. Sept. 6, 2007 (affirming dismissal of fraudulent transfer claim after concluding debtor had no interest in the property transferred).

A “transfer of an interest of the debtor in property” is an essential element of a claim under § 547, § 548, and § 544. Given the fact that § 547, § 548, and § 544 share identical language, it is hard to see why the earmarking doctrine, which focuses on the “interest of the debtor in property,” should not apply to preferential transfers and fraudulent transfers alike. This Court is persuaded by the analysis of *TriGem America Corp.*, 431 B.R. 855. In that case, the court held that the earmarking doctrine could be asserted in a fraudulent transfer proceeding, explaining its rationale as follows:

> In the Court’s view it is far more illuminating to consider the theoretical underpinnings of the earmarking doctrine. The earmarking doctrine is entirely a court-made interpretation of the statutory requirement that a voidable preference (or arguably a fraudulent conveyance) must

> involve a "transfer of an interest of the debtor in property." *In re Bohlen Enterprises Ltd.*, 859 F.2d at 565. But "transfer of an interest of the debtor in property" is equally a statutory requirement of an action under § 548(a)(1) as it is for preferences. If creditors have no other right or expectation of resort to property which has been transferred to a debtor for an earmarked purpose, then why should it matter that the theory of avoidance of that property's transfer is in preference or fraudulent conveyance? In both instances what matters is that in an earmark case there is no diminishment of the estate, and it is that diminishment of assets that would otherwise be available to pay creditors that is at the heart of all avoidance actions. . . . Reduced to its essence, the earmarking defense merely holds for the unsurprising conclusion that where creditors would not otherwise have any reason or expectation to look to the assets transferred, there is no diminution of the net recovery on account of the earmarked funds and there can therefore be no avoidance. It is not so much an affirmative defense as it is a challenge to the trustee's claim that the particular funds are part of the bankruptcy estate.

431 B.R. at 864 (citations and footnotes omitted).

Another bankruptcy court had the opportunity to analyze a factoring agreement under the earmarking doctrine and found that the transaction did not constitute a preference or a fraudulent transfer. *See Dependable Auto Shippers, Inc.*, 2018 WL 4348049. In that case, the debtor-to-be, Dependable Auto Shippers ("Dependable"), entered into a factoring agreement with TBK Bank, SSB ("Old Creditor"). This additional funding proved insufficient due to unanticipated accounting errors related to expenses and a steady decline in revenue and increased debt, so Dependable's top ten largest corporate accounts suspended service, resulting in the loss of more than 80% of the prior year's revenue. Dependable contacted one of its largest vendors ("New Creditor"), and eventually, New Creditor agreed to loan Dependable enough money to pay off Old Creditor under the parties' factoring agreement and cover other expenses. New Creditor agreed to lend Dependable up to $1,200,000 in exchange for a security interest in all assets. It also agreed to extend additional financing after the bankruptcy filing, subject to certain conditions. Dependable requested a payoff letter from Old Creditor, and New Creditor wired $1,070,906 to Dependable's operating account. The same day, Dependable wired $755,906 to Old Creditor to satisfy the debt owed to Old Creditor. The next day, Dependable filed a Chapter 11 case. The trustee sued Old Creditor to avoid the pre-bankruptcy transfer under § 547 and § 548.

The court concluded that the earmarking doctrine barred the trustee's avoidance action under § 547 and § 548. It determined that the funds New Creditor loaned to Dependable were not "an interest in property" of Dependable, even though the funds passed through Dependable's bank account. The court evaluated Dependable's level of control over the funds. The court reviewed the totality of the circumstances and found that the parties intended that Dependable transfer the funds from New Creditor directly to Old Creditor. The court concluded that Dependable never had control over the funds because the agreement deprived Dependable of dominion or control over the funds. Because New Creditor had agreed to lend Dependable additional funds after Dependable filed for bankruptcy, the loan was structured so that Old Creditor's debt had to be satisfied before New Creditor would advance additional funds. For New Creditor to take a first position lien on all of Dependable's assets, Old Creditor had to release its security interest, and for Old Creditor to release its security interest, it had to receive payment in full. Dependable was merely a conduit to facilitate repayment of Old Creditor and all that really occurred was the substitution of one creditor for another — Old Creditor for New Creditor. The fact that the funds were in Dependable's account for forty-five minutes was deemed irrelevant by the court because control and not simple possession determines the availability of the earmarking doctrine and whether funds are property of a debtor for purposes of avoidance actions.

The case currently before this Court is remarkably similar to the *Dependable Auto Shippers* case. LSQ is the old creditor and Millennium is the new creditor. Millennium, as the new creditor, wired LSQ, the old creditor, $10,306,661.56 in exchange for LSQ's release of its interest in the Debtor's accounts. Engstrom, the debtor, had even less control over the funds than the debtor in *Dependable Auto Shippers*. The funds never passed through Engstrom's account. Millennium wired the funds directly to LSQ. The Debtor was not a conduit to facilitate repayment to LSQ. All that really occurred was substitution of one creditor for another — Millennium for LSQ. Millennium simply bought out LSQ and took its place by entering into its own factoring agreement with the Debtor.

In summary, the earmarking doctrine applies to the Trustee's § 547, § 548, and § 544 claims against LSQ. The Debtor had no control over the funds wired from Millennium to LSQ. The transfer of $10,306,661.56 from Millennium directly to LSQ was not a "transfer of an interest of the debtor in property" within the meaning of § 547, § 548, or § 544. The transaction merely substituted one secured lender for another and it resulted in no diminution of the Debtor's estate.

The Trustee further argues that the "diminution of the estate doctrine" does not apply to intentionally fraudulent transfers under § 548. Section 548(a)(1)(A) permits a trustee to avoid "any transfer of an interest of the debtor in property" or any obligation incurred by the debtor that was made or incurred on or within two years of the date of the filing of the petition if the debtor voluntarily or involuntarily:

> made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted.

The Trustee notes that "under the plain language of § 548(a)(1)[A], the inquiry is not whether . . . creditors were harmed by the [allegedly fraudulent transfer], but whether [the debtor] intended to hinder, delay or defraud its creditors when it made [the allegedly fraudulent transfer]." *See In re Model Imperial, Inc.*, 250 B.R. 776, 793 (Bankr. S.D. Fla. 2000). The Trustee goes on to argue that if diminution of the estate were an essential element of a § 548(a)(1)(A) claim, § 548(a)(1)(B), which requires the debtor to have received less than reasonably equivalent value in exchange for such transfer or obligation, would be redundant. *Id.* at 793-94.

The Trustee cites to various cases for the proposition that he does not need to prove actual harm to maintain a claim for a fraudulent transfer. *In re All Phase Roofing & Constr., LLC*, 2020 WL 5512500, at *7 (B.A.P. 10th Cir. Sept. 14, 2020) ("Actual harm to creditors is not an element of a claim under § 548(a)(1)(A)."); *In re Galbreath*, 2002 WL 34721371, at *3 n.3 (Bankr. S.D. Ga. Dec. 16, 2002) ("Although proof of lack of equivalent value is expressly required for avoidance based on constructive fraud, see 11 U.S.C. § 548(a)(1)(B), a trustee's burden in an avoidance action based on actual fraud is limited to proof of the debtor's intent to hinder, delay or defraud creditors."); *In re Feynman*, 77 F.2d 320, 322 (2d Cir. 1935) ("once the fraud be proved, it makes no difference that the creditors are not seriously injured . . . The law forbids all efforts to put property beyond the reach of creditors, no matter what its value; so long as courts are tolerant of such conduct, men will engage in it and the purposes of the bankruptcy act will be balked."); *In re Sherman*, 67 F.3d 1348, 1355 n.6 (8th Cir. 1995) ("under § 548(a)(1)[(A)], actual harm is not required; the trustee must show only that the debtor acted with the intent to hinder, delay or defraud creditors. 'While ordinarily there is no reason for a trustee to seek, or a court to exercise its power, to avoid a transfer which has not harmed anyone, it is to be emphasized that fraud may be committed under section 548(a)(1)[(A)] even though a fairly equivalent consideration may pass to the transferor and even though creditors are merely hindered or delayed.'"); *Tavenner v. Smoot*, 257 F.3d 401, 407 (4th Cir. 2001) ("Nothing in § 548 indicates that a trustee must establish that a fraudulent conveyance actually harmed a creditor . . . Rather, § 548 states that '[t]he trustee may avoid *any* transfer of an interest of the debtor in property' if the transfer or obligation is entered into with the requisite intent.").

The Trustee claims that because he has alleged that the Debtor committed an intentionally fraudulent transfer under 11 U.S.C. § 548(a)(1)(A) and under 11 U.S.C. § 544(b) and Wis. Stat. § 242.04(1)(a), those two claims survive any finding by this Court that the Debtor's estate was not diminished by the transfer of borrowed funds from Millennium to LSQ.

The problem with the Trustee's argument is that it ignores one of the statutory elements of a fraudulent transfer claim, namely that there must be a "transfer of an interest of the debtor in property." In each of the cases cited by the Trustee, there was a transfer of an interest of the debtor in property. *All Phase Roofing*, 2020 WL 5512500, at *2 (debtor's interest in real property, truck, and cargo trailer fraudulently transferred to debtor's president would have been part of bankruptcy estate); *Model Imperial, Inc.*, 250 B.R. at 793-94 (debtor's interest in payments made to lender through alleged corporate shell would have been part of bankruptcy estate); *Galbreath*, 2002 WL 34721371, at *1 (debtor's interest in parcels of real estate that were subject of fraudulent transfer action would have been part of bankruptcy estate); *Feynman*, 77 F.2d at 321 (debtor's interest in life insurance policy fraudulently transferred to wife would have been part of bankruptcy estate); *Sherman*, 67 F.3d at 1351-52 (debtor's interest in twelve properties fraudulently transferred to parents would have been part of bankruptcy estate); *Tavenner*, 257 F.3d at 405 (debtor's interest in settlement proceeds would have been part of bankruptcy estate). At most, the cases cited by the Trustee show that where there is a transfer of an interest of the debtor in property, some courts hold that the lack of harm to a creditor (because the property was exempt, fully encumbered, or of nominal value) does not provide a defense to a fraudulent transfer claim.

By contrast, in this case, there has been no transfer of an interest of the debtor in property because of the earmarking doctrine, the Debtor's lack of control over the transfer from Millennium to LSQ, and because the transfer from Millennium to LSQ did not result in diminution of the Debtor's estate. Without a transfer of an interest of the debtor in property, there can be no preference or fraudulent transfer claim as a matter of law.

Conclusion

For the reasons stated above, the earmarking doctrine applies in this case. No transfer of an interest of the debtor in property occurred under 11 U.S.C. § 544(b), § 547, or § 548, and the Chapter 7 Trustee is unable to avoid the challenged transfer. Accordingly,

IT IS THEREFORE ORDERED: LSQ Funding Group, L.C.'s Motion for Summary Judgment is granted and the Court will enter judgment in favor of LSQ.

So Ordered.

Dated: August 31, 2021

/s/ Katherine Maloney Perhach
Katherine Maloney Perhach
United States Bankruptcy Judge

APPENDIX D — DENIAL OF REHEARING OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT, DATED JULY 21, 2023

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 22-2436

DOUGLAS F. MANN,

Appellant,

v.

LSQ FUNDING GROUP, L.C.,

Appellee.

July 21, 2023, Decided

Appeal from the United States District Court
for the Eastern District of Wisconsin.

No. 2:21-cv-01070-BHL

Brett H. Ludwig, *Judge.*

Before

KENNETH F. RIPPLE, *Circuit Judge*

MICHAEL Y. SCUDDER, *Circuit Judge*

AMY J. ST. EVE, *Circuit Judge*

ORDER

On consideration of the petition for rehearing and petition for rehearing en banc, no judge in regular active service has requested a vote on the petition for rehearing en banc and the judges on the original panel have voted to deny rehearing. It is, therefore, **ORDERED** that the petition for rehearing and petition for rehearing en banc is **DENIED**.

APPENDIX E — RELEVANT STATUTORY PROVISIONS

11 U.S.C. § 541

§ 541. Property of the estate

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is--

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

(3) Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title.

* * * *

Appendix E

11 U.S.C. § 544

§ 544. Trustee as lien creditor and as successor to certain creditors and purchasers

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by--

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

(b)(1) Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

(2) Paragraph (1) shall not apply to a transfer of a charitable contribution (as that term is defined in section 548(d)(3)) that is not covered under section 548(a)(1)(B), by reason of section 548(a)(2). Any claim by any person to recover a transferred contribution described in the preceding sentence under Federal or State law in a Federal or State court shall be preempted by the commencement of the case.

Appendix E

11 U.S.C. § 548

§ 548. Fraudulent transfers and obligations

(a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily--

> **(A)** made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

* * *

(c) Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

* * * *

Appendix E

W.S.A. 242.04

242.04. Transfers fraudulent as to present and future creditors

(1) A transfer made or obligations incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(a) With actual intent to hinder, delay or defraud any creditor of the debtor; or

* * * *

Appendix E

W.S.A. 242.08

242.08. Defenses, liability and protection of transferee

(1) A transfer or obligation is not voidable under s. 242.04(1)(a) against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee.

* * * *