No. 23-425

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 Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## BRIEF IN OPPOSITION


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## QUESTION PRESENTED

The Bankruptcy Code allows a trustee to avoid certain transfers, made before the bankruptcy filing, of "*an interest of the debtor in property*." 11 U.S.C. §§ 544(b), 547(b) & 548(a)(1). Is a transfer of property that would not have been part of the bankruptcy estate, if it had not been made, a transfer of "an interest of the debtor in property," subject to avoidance?

## CORPORATE DISCLOSURE STATEMENT

Respondent LSQ Funding Group, L.C. is a wholly owned subsidiary of LSQ Group LLC. No publicly held company owns ten percent or more of LSQ Group LLC.

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## INTRODUCTION

A bankruptcy trustee may avoid and recover for the benefit of the estate certain types of transfers that occur before the case is filed. The requirements to qualify for avoidance vary, depending on which of the Code's provisions the trustee invokes, but each provision requires that the transfer be of "an interest of the debtor in property." 11 U.S.C. §§ 548(a)(1) (fraudulent transfers under the Code itself), 544(b) (one of a trustee's "strong-arm" powers to avoid transfers under state law) & 547(b) (preferential transfers).

The petitioner Trustee invoked all three avoidance provisions in his effort to avoid a prefiling transfer of $10.3 million to the respondent, LSQ, asserting that the transfer was preferential under § 547(b) and fraudulent under §§ 548(a)(1) and 544(b). The Seventh Circuit affirmed dismissal of all three claims on the same ground: The challenged transfer was not of "an interest of the debtor in property."

The Trustee asks this Court to review a different question, one that the Seventh Circuit declined to answer as unnecessary to resolve the case: Whether a transfer made with actual intent by the debtor to defraud creditors can be avoided under §§ 548(a)(1)(A) and § 544(b), even if the transfer did not adversely affect the bankruptcy estate. The Trustee attempts to satisfy the criteria for certiorari review by saying that the Seventh Circuit's decision conflicts with decisions of the Second and Fourth Circuits, which hold, according to the Trustee, that "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." Pet. 9.

The Trustee's characterization of the decision below is inaccurate, and there is no circuit split. In holding that the transfer he challenges was not of "an interest of the debtor in property," the Seventh Circuit relied on this Court's decision in *Begier v. IRS*, 496 U.S. 53 (1990), which explained that "an interest of the debtor in property" under the Code's avoidance provisions "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 58–59 & n.3. Relying on the Trustee's concession that the transferred funds would not have been part of the debtor's estate if the transfer had not been made, the court held that the transfer was not of "an interest of the debtor in property." Because the transfer did not satisfy this common statutory prerequisite for avoidance actions, the court declined to consider whether the further, specific requirements to establish fraud under §§ 548(a)(1)(A) and 544(b) were satisfied.

The Seventh Circuit's decision fully accords with the decisions of the Second and Fourth Circuits upon which the Trustee relies. Like the Seventh Circuit, these other courts hold that a transfer must be of "an interest of the debtor in property" to come within the reach of a trustee's avoidance powers. Only a transfer that satisfies this threshold requirement makes it necessary for a court to examine whether the specific elements of a fraud claim under §§ 548(a)(1)(A) and 544(b) are satisfied.

LSQ will not here address the merits of the Seventh Circuit's correct decision, because the absence of the Trustee's posited circuit split demonstrates that the case does not qualify under Rule 10(a) for the Court's attention. The petition should be denied.

## STATEMENT

The Trustee's adversary proceeding sought to avoid a wire transfer of $10.3 million that non-party Millennium Funding sent directly to LSQ to pay off what the debtor owed LSQ.

LSQ is a lender that factors accounts receivable. Adv. Dkt. 49 at 1, ¶ 1.[1] The debtor provided staffing services to its customers and, until early 2020, financed its business by selling its accounts to LSQ under an Invoice Purchase Agreement. Adv. Dkt. 49 at 2–3, ¶¶ 2–5. LSQ advanced 85% of the face amount of the debtor's invoices. Adv. Dkt. 49 at 2–3, ¶ 5. After a customer paid an invoice, LSQ funded the balance to the debtor, less an agreed-upon amount for its services. *Id.*

On January 9, 2020, LSQ terminated the agreement and exercised its contractual right to require the debtor to repurchase all unpaid invoices. Adv. Dkt. 49 at 3–4, ¶¶ 6, 8–9. On January 11, the debtor's principal told LSQ that the debtor was working with another lender to secure funds to pay off the amount owed to LSQ. Adv. Dkt. 49 at 4, ¶ 11. About two weeks later, the debtor entered into a

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[1] References to the "Adv. Dkt." are to docket entries in No. 20-02062-kmp (Bankr. E.D. Wis.).

factoring agreement with Millennium, one of LSQ's competitors. Adv. Dkt. 49 at 4, ¶ 12. At the debtor's request, LSQ sent Millennium and the debtor a payoff letter with the amount required to satisfy what the debtor still owed: $10,306,661.56. Adv. Dkt. 49 at 4, ¶ 13.

On January 28, Millennium initiated a wire transfer directly to LSQ in the amount of $10,306,661.56. Adv. Dkt. 49 at 4, ¶ 15. Millennium and the debtor had agreed that Millennium would advance this sum directly to LSQ for the sole purpose of paying off the debtor's obligations to LSQ. Adv. Dkt. 49 at 5, ¶ 22. After receiving the payoff money from Millennium, LSQ terminated its UCC security interest in the accounts and other collateral. Adv. Dkt. 49 at 6, ¶ 28. Under its agreement with Millennium, the debtor assigned those same accounts to Millennium and granted it a security interest in all collateral that had secured its obligations to LSQ. Adv. Dkt. 49 at 5–6, ¶¶ 21 & 29. The payoff thus effected an exchange of creditors. Immediately before LSQ received the payoff, the debtor owed LSQ $10,306,661.56. Adv. Dkt. 49 at 6, ¶ 25. Immediately afterward, the debtor no longer owed LSQ anything. Instead, it owed Millennium not less than $10,306,661.56. Adv. Dkt. 49 at 6, ¶¶ 26–27.

The debtor filed a voluntary Chapter 11 petition on April 15, 2020, and initiated an adversary proceeding on May 4, seeking to avoid the payoff as a preference under 11 U.S.C. § 547(b). Pet. App. 38a–39a. Three months later, the debtor amended its complaint to add a claim under 11 U.S.C. § 548(a)(1). Adv. Dkt. 6. Subsequently, the bankruptcy case was converted to Chapter 7, and the Trustee was appointed. Pet. App. 39a. He then filed a second amended complaint to add a state-law fraudulent transfer claim under 11 U.S.C. § 544(b) (invoking Wisconsin's version of the Uniform Fraudulent Transfer Act). Adv. Dkt. 34.

After discovery, LSQ moved for summary judgment dismissing all the claims, contending that the Trustee had failed to satisfy his burden under the language of all three avoidance statutes to establish that the payoff was a transfer of "an interest of the debtor in property." Adv. Dkt. 47–49.

The bankruptcy court granted the motion and dismissed all the Trustee's claims. Pet. App. 31a–83a. Both the district court and the Seventh Circuit affirmed the dismissal. Pet. App. 14a–30a; Pet. App. 1a–13a.

## REASONS FOR DENYING THE PETITION

The petition does not satisfy Rule 10(a), upon which it relies, because there is no conflict among the circuits on the question decided by the Seventh Circuit. In affirming dismissal of the claims under the Bankruptcy Code's fraudulent transfer provisions, the Seventh Circuit was clear about what it was deciding: "the antecedent question of what kinds of transfers affect the bankruptcy estate in the first place." Pet. App. 13a. The court was also clear about what it was *not* deciding: "questions about good faith, actual fraud, and constructive fraud" under the fraudulent transfer provisions specifically. *Id.*

Despite what the Seventh Circuit said it was and was *not* deciding, the Trustee contends that its decision widens a supposed circuit split regarding what it takes to establish fraud under 11 U.S.C. §§ 548(a)(1)(A) and 544(b). According to the Trustee, "the Seventh Circuit sided with the Eleventh Circuit and other lower courts that adopted a diminution test for fraud" and against the Second and Fourth Circuits, which the Trustee says "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." Pet. 3.

The Seventh Circuit certainly did *not* adopt a "diminution test for fraud." Its discussion of the "diminution of the estate" concept related only to the threshold question whether the $10.3 million payoff was of "an interest of the debtor in property." Contrary to what the Trustee asserts, decisions of the Second and Fourth Circuits likewise consider "diminution of the estate" to be part of this threshold inquiry. These courts—like the Seventh Circuit—recognize that harm to the estate is not needed to establish fraud itself under §§ 548(a)(1)(A) and 544(b). These courts also recognize—again like the Seventh Circuit—that the issue of fraud need only be addressed if the transfer that a trustee seeks to avoid was of "an interest of the debtor in property."

## I. The Seventh Circuit Did Not Adopt a "Diminution Test for Fraud."

The petition's central premise—that the Seventh Circuit "adopted a diminution test for fraud" under §§ 548(a)(1)(A) and 544(b), Pet. 3—misstates what the court said. The Seventh Circuit's decision begins and ends with the prefatory language common to each of the Code's avoidance provisions: A trustee may avoid transfers of "an interest of the debtor in property." 11 U.S.C. §§ 548(a)(1), 544(b) & 547(b). *See* Pet. App. 6a ("*That language is key to this case*.").

To define "an interest of the debtor in property," the Seventh Circuit looked to this Court's decision in *Begier*, which explained that the statutory phrase common to the avoidance powers "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." Pet. App. 6a (quoting *Begier*, 496 U.S. at 58). The court also looked to its own decision in *Matter of Smith*, 966 F.2d 1527 (7th Cir. 1992), which "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." *Id.* The court explained that "[t]he 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." *Id.*

Applying this framework, the court concluded that "a diminution of estate analysis shows plainly that the transaction at issue here did not involve 'an interest of the debtor in property,'" because "[t]he parties agree[d] that neither the $10.3 million nor the accounts sold would have been part of the Debtor's estate." Pet. App. 8a. As the court explained, "the funds never actually passed through the [d]ebtor's accounts," and the summary judgment record contained "no evidence … 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." Pet. App. 7a–8a & n.4. In other words, the transferred funds would not have been available to bankruptcy creditors even if the transfer had not occurred. This conclusion was dispositive of each of the Trustee's avoidance claims because each required "a showing that the transfers were of 'an interest of the debtor in property.'" Pet. App. 13a.

The Trustee's insistence that the Seventh Circuit "adopted a diminution test for fraud" ignores what the court actually said about the limits of its decision. In rejecting his argument that "considering … diminution of the estate in the context of § 548(a) creates conflicts elsewhere in the provision," including with respect to "the distinctions between actual fraud under § 548(a)(1)(A) and constructive fraud under § 548(a)(1)(B)," the court emphasized that it was *not* deciding what is required to establish fraud under those provisions: "[O]ur 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." Pet. App. 12a–13a.

## II. The Seventh Circuit's Decision Does Not Conflict with Decisions of the Second and Fourth Circuits.

The Trustee maintains that the Seventh Circuit's decision widened "a clear conflict among the courts of appeals" and criticizes the decision for "fail[ing] to cite to this split," Pet. 9, without acknowledging that he first mentioned the existence of a supposed circuit split in his petition for rehearing *en banc*. The petitioner relies primarily on *HBE Leasing Corp. v. Frank*, 48 F.3d 623 (2d Cir. 1995)—a decision that he cited only in a "*see also*" footnote in his opening brief, before mentioning it again in his rehearing petition—and *Tavenner v. Smoot*, 257 F.3d 401 (4th Cir. 2001)—a decision that he never cited in any of his submissions to the Seventh Circuit.

The Trustee did not highlight these decisions to the Seventh Circuit for good reason: They do not conflict with its decision. *HBE* does not address the only issue that the Seventh Circuit decided—whether the challenged transfer involved "an interest of the debtor in property"—and *Tavenner* confirms the need to satisfy this threshold requirement before undertaking any inquiry into fraud under § 548(a)(1)(A). Other decisions from the Second and Fourth Circuits that the Trustee either cites here without discussion or fails to cite altogether make clear that these circuits, like the Seventh, consider whether a transfer diminished the bankruptcy estate as part of the threshold inquiry into whether the transfer was of "an interest of the debtor in property."

### a. *There Is No Conflict with Decisions of the Second Circuit.*

There is no conflict between the decision below and the Second Circuit's decision in *HBE* because *HBE* does not even address the avoidance provisions' threshold requirement of "an interest of the debtor in property." Rather, the question was whether the debtor's payment of nearly $800,000 to its attorneys could be deemed fraudulent under New York's fraudulent transfer statute to the extent that the debtor received fair consideration in the form of legal services. *HBE*, 48 F.3d at 637–38. Focusing solely on what the statute requires to establish fraud, the court held that adequate consideration was irrelevant because "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." *Id.* at 639.

When the Second Circuit *has* addressed the threshold requirement of "an interest of the debtor in property," it has used the same diminution analysis that the Seventh Circuit used below. *See In re Picard, Tr. for Liquidation of Bernard L. Madoff Inv. Secs. LLC*, 917 F.3d 85 (2d Cir. 2019). *Picard*, which the Trustee cites without discussion, dealt with fallout from a Ponzi scheme involving transfers of property first by the debtor to foreign entities, and then by those foreign entities to other foreign entities. *Id.* at 92–93. The trustee sought to avoid and recover the transfers under § 548(a)(1)(A) and 11 U.S.C. § 550(a)(2) (liability of immediate or mediate transferee of initial transferee). The issue was whether the usual presumption against applying statutes extraterritorially precluded recovery under § 550(a)(2). *Id.* at 91. The Second Circuit concluded that the anti-extraterritoriality presumption did not apply because the trustee's efforts to recover the transferred property constituted a domestic, rather than a foreign, application of the statute. *Id.* at 91, 99–100. In arriving at this conclusion, the court explained that § 550(a)(2) works "in tandem" with the Code's avoidance provisions, including § 548(a)(1)(A), and thus required the court to consider the conduct that § 548(a)(1)(A) regulates. *See id.* at 97.

Central to the court's conclusion that § 548(a)(1)(A) regulates domestic conduct was the statute's purpose, which the Second Circuit explained is to "allow[] a trustee, for the protection of an estate and its creditors, to avoid a debtor's fraudulent, hindersome, or delay-causing property transfer *that depletes the estate*." *Id.* at 97–98 (emphasis added). Because "the harm to the estate as a result of its unlawful depletion began with the initial transfer" from the debtor, the court concluded that the trustee's efforts to recover the transferred property were a domestic application of § 550(a)(2). *Id.* at 97, 100.

Both *Picard* and *HBE* are consonant with the Seventh Circuit's decision below. As *Picard* recognizes, a transfer must affect the bankruptcy estate to fall within the scope of the avoidance powers generally; questions of actual and constructive fraud, like those addressed in *HBE*, only arise after a trustee has satisfied this threshold requirement. *Cf.* Pet. App. 13a ("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."). There is no conflict between the Seventh Circuit's decision and the decisions of the Second Circuit.

b. *There Is No Conflict with Decisions of the Fourth Circuit.*

The Seventh Circuit's decision likewise accords with *Tavenner*, which recognized that whether a transfer was of "an interest of the debtor in property," *i.e.*, property that would have been part of the bankruptcy estate had the transfer not been made, is the threshold question under any of the Code's avoidance provisions. The *Tavenner* transfer was of litigation settlement proceeds that would have been eligible for an exemption from the bankruptcy estate if the debtor had not transferred them. *Tavenner*, 257 F.3d at 406. The trustee sought to avoid the transfer as fraudulent under § 548(a)(1)(A). *Id.* at 407. In holding that the transfer was subject to avoidance, the Fourth Circuit undertook a two-step analysis.

First, it considered whether a transfer of exempt property is subject to avoidance generally. *See id.* at 406. Central to this step of its analysis was the determination that a transfer of exempt property has the potential to harm creditors by depleting the assets that would otherwise have been available to them in bankruptcy: "[U]nder the bankruptcy laws, as revised in 1978, all property, including potentially exempt property, is part of the bankruptcy estate until the debtor claims an exemption for it; consequently, a transfer of potentially exempt property could harm creditors because it might not have actually been exempted from the bankruptcy estate." *Id.* Because "[p]otentially exempt property can be used to satisfy the demands of the creditors if the debtor never claims the exemption," the Fourth Circuit "conclude[d] that transfers of potentially exempt property are amenable to avoidance and recovery actions by bankruptcy trustees." *Id.* at 407.

Only after concluding that exempt property is subject to avoidance generally did the court in *Tavenner* go on to consider "whether [the debtor] can be held to have transferred the … settlement proceeds fraudulently." *Id.* The court explained that harm to creditors was irrelevant to this part of its analysis: "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.*

The Trustee not only ignores the first part of the court's analysis in *Tavenner*; he also fails to cite the Fourth Circuit's more recent decision in *In re Derivium Capital LLC*, 716 F.3d 355 (4th Cir. 2013), in which the court recognized that diminution of the estate is a prerequisite under the Code's avoidance provisions, including under §§ 548(a)(1) and 544(b). *Derivium* also involved a Ponzi scheme. After customers put their stocks into the defendant bank's brokerage accounts, the debtor directed the bank to transfer the stocks into other accounts and to liquidate them to fund other customer loans. *Id.* at 359. When the scheme collapsed and the debtor filed for bankruptcy, the trustee sought to avoid and recover the securities that customers had transferred to the bank's brokerage accounts as fraudulent transfers under §§ 544(b) and 548(a)(1). *Id.*

Without any discussion of actual or constructive fraud, the Fourth Circuit held that the transfers were not subject to avoidance because they were not "transfers of 'an interest of the debtor in property or any obligation incurred by the debtor' as required by 11 U.S.C. §§ 544(b)(1) and 548(a)." *Id.* at 361. The court explained: "There is no dispute that [the debtor] had no rights to the securities until *after* the transfers were effectuated. Accordingly, the [transfers] at issue here simply were not transfers of debtor property, and thus the transfers in no way diminished the bankruptcy estate." *Id.* at 361.

*Tavenner* and *Derivium* thus align squarely with the Seventh Circuit's recognition that "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." Pet. App. 11a–12a. There is no conflict between the Seventh Circuit's decision and decisions of the Fourth Circuit and no ground in Rule 10(a) to obtain review from this Court.

## CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted,

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