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Seventh Circuit Holds Transfer that Does Not Diminish Estate is not Avoidable as Preferential or Fraudulent Transfer

In *Mann v. LSQ Funding Group*, L.C. [1], the U.S. Court of Appeals for the Seventh Circuit affirmed the District Court's dismissal of claims to avoid certain pre-petition transfers as preferential or fraudulent because they did not diminish the debtor's estate.

In June 2018, LSQ Funding Group, L.C. ("LSQ") entered into an agreement with the Debtor to provide factoring services. LSQ terminated its agreement with the Debtor in January 2020, resulting in a $10.3 million obligation by the Debtor to LSQ. The Debtor entered into an agreement with Millennium Funding ("Millennium"). Millennium satisfied the $10.3 million debt by paying LSQ directly, in exchange for LSQ releasing any rights that it had in the Debtor's invoices, now assigned to Millennium. Within three months of this transaction, the Debtor filed for bankruptcy.

The Chapter 7 Trustee ("Trustee") claimed that the agreement with LSQ was a sham, part of a larger fraud perpetrated by the Debtor's CEO. The Trustee alleged that the CEO ran a "Ponzi" scheme by: (i) entering into factoring agreements based on fictitious accounts; (ii) fabricating invoices from fake companies; (ii) selling those invoices to companies such as LSQ through factoring agreements; and (iv) then paying the invoices using money from other fraudulent agreements. The Trustee asserted that the Debtor and its CEO conspired with LSQ to defraud Millennium and use the proceeds to pay the Debtor's obligation to LSQ.

The Trustee commenced an action against LSQ to avoid the $10.3 million payment to LSQ as a preferential transfer under § 547(b) or a fraudulent transfer under § 548(a)(1). The bankruptcy court entered summary judgment in favor of LSQ based upon the "earmarking doctrine," which exempts certain financial transactions from avoidance under § 547(b) where a creditor provides a debtor "earmarked" funds to satisfy a specific obligation, thereby assuming the original creditor's position – i.e., there is no additional obligation incurred from the debtor's perspective, and the debtor's creditors are no worse off. The Trustee appealed, and the district court affirmed. The Trustee then appealed to the Seventh Circuit.

Bankruptcy Code § 547 provides a mechanism for the trustee of a bankruptcy estate to avoid transactions that favor certain creditors over others made within ninety (90) days of the bankruptcy filing. Specifically, § 547(b) provides that "the trustee may, based on reasonable due diligence in the circumstances of the case, and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any **transfer of an interest of the debtor in property**..." 11 U.S.C. §547(b) (emphasis added). The Seventh Circuit found the bolded phrase "key" to the case.

The Seventh Circuit used two approaches to determine whether a transfer has affected an interest of the debtor in property: (1) whether the debtor could exercise control over the funds transferred; and (2) whether the transfer diminished the property of the estate.

[1] *Mann v. LSQ Funding Group, L.C. (In re Engstrom, Inc.)*, 2023 WL 4142025 (7th Cir. June 22, 2023).

The Seventh Circuit held that a reasonable jury could find satisfaction of the "control requirement" under these circumstances, because the Debtor could direct the transfer from Millennium to LSQ. However, the Seventh Circuit held that it need not to decide the control question since the "diminution of estate" analysis plainly showed that the transaction at issue did not involve an interest of the Debtor in property.

The Seventh Circuit found that neither the $10.3 million transfer by Millennium to LSQ, nor the accounts sold to Millennium were part of the Debtor's estate, as the funds never actually passed through the Debtor's accounts. The Seventh Circuit specifically referred to the Trustee's "admission" at oral argument that this transaction had "no adverse effect, no diminution … on other creditors." Therefore, the Court held that the transfer at issue did not involve "an interest of the debtor in property" and was not avoidable as a preferential transfer under § 547.

The Seventh Circuit further held that the transfer by Millennium to LSQ did not constitute a fraudulent transfer under Bankruptcy Code § 548, which also permits the avoidance of a "transfer of an interest of the debtor in property" (along with other requirements). In addition to the reasons set forth above, the Seventh Circuit held that there was no evidence in the record that Millennium would have paid the Debtor directly absent the transaction with LSQ. If the payoff agreement was reversed, the $10.3 million would be returned to Millennium and not to the Debtor's estate, which is the purpose of a trustee's avoidance powers. Therefore, according to the Seventh Circuit, avoidance of the transfer to LSQ would benefit only Millennium, not any other creditors of the estate.

The Court noted that its decision that the subject transfer was not fraudulent under § 548 "aligns comfortably with those of [its] sister circuits" (4th, 6th, and 11th circuits) as "[o]utright 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." Therefore, the Court held that the transfer at issue—even though orchestrated to foster a Ponzi scheme—did not have an "impact on the property of the Debtor [and] this is not the type of fraud governed by the Bankruptcy Code." [2]

The Seventh Circuit's decision has significant implications for debtors, creditors and trustees seeking to recover assets for the estate, including avoiding preferential or fraudulent transfers. The Seventh Circuit joined the Fourth, Sixth and Eleventh circuits declining to expand avoidance powers to outright fraud claims. Debtors, trustees and creditors must strategize these potential claims to assess whether there was a "transfer of an interest of the debtor in property", and potentially utilize alternative claims to pursue recovery of assets for the estate.

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[2] The Second Circuit (unlike the Fourth, Sixth, Seventh, and Eleventh Circuits) recognizes a "Ponzi scheme presumption" to avoid fraudulent transfers pursuant to 11 U.S.C. § 548, pursuant to which the existence of a Ponzi scheme demonstrates the actual intent to hinder, delay, or defraud creditors as a matter of law. *See In re Bernard L. Madoff Investment Securities LLC*, 12 F.4th 171 (2d Cir. 2021).).