So Ordered.

Dated: August 31, 2021

Katherine M. Perhach
Katherine Maloney Perhach
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF WISCONSIN

In re:
Engstrom, Inc.,
Debtor.

Chapter 7
Case No. 20-22839-kmp

Douglas F. Mann,
as Chapter 7 Trustee of the estate of
Engstrom, Inc.,
Plaintiff,

v.

Adv. No. 20-2062

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.

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).

<u>Statement of Facts</u>

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:

> 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).

[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.*

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:

> <u>REQUEST TO ADMIT NO. 12</u>: 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.

> <u>INTERROGATORY NO. 17</u>: 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] 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.

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

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[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 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.

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)*, 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.

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