Dated: October 05, 2011
The following is ORDERED:

Jennie D. Latta
UNITED STATES BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE

In re

CECIL RAY DAVIS, Case No. 05-15794- GWE
Chapter 7

Debtor.

MICHAEL TABOR,
Chapter 7 Trustee,
Plaintiff,
v. Adv. Proc. No. 07-05181-L
CHARLES KELLY, SR.,
Defendant.

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW ON CROSS MOTIONS FOR SUMMARY JUDGMENT

BEFORE THE BANKRUPTCY COURT are cross motions for summary judgment filed by the Plaintiff and the Defendant in this adversary proceeding, which was commenced by the Trustee on July 7, 2007, seeking the avoidance and recovery of allegedly fraudulent and/or preferential transfers arising from a Ponzi scheme perpetrated by the Debtor, Cecil Ray Davis. Before considering the substance of the parties' arguments, however, the court must first determine whether a bankruptcy judge has authority to hear and finally determine the claims asserted in this adversary proceeding. Because I conclude that bankruptcy courts do not have that authority, but may make a report and recommendation to the district court, I make the following report and recommendation to the district court.

I.

The bankruptcy case of Cecil Ray Davis was commenced by the filing of an involuntary petition pursuant to section 303 of the Bankruptcy Code on December 22, 2005. The Defendant Charles Kelly, Sr. was one of the petitioning creditors, but he has not filed a proof of claim. *See* Dkt. No. 1 and Claims Register. Davis filed an answer to the petition and a hearing was conducted which resulted in the entry of an order for relief on February 2, 2006. The Plaintiff, Michael T. Tabor, was appointed trustee on February 6, 2006. The Trustee filed some 110 adversary proceedings to recover for the benefit of the estate funds paid out by the Debtor to various persons in the years preceding his bankruptcy filing. The complaint against Kelly is one of those adversary proceedings.

The complaint alleges that the Debtor operated a number of businesses in the years prior to the filing of the involuntary petition in furtherance of a Ponzi scheme. It alleges that the Debtor was insolvent from at least 1999 through the date of the order for relief [February 2, 2006]. It alleges that the Debtor entered a plea agreement in the United States District Court for the Western District of Tennessee, in which he admitted a scheme and artifice to defraud by way of a Ponzi scheme. It alleges that the Defendant, Charles Kelly, Sr., received $52,150 from the period December 22, 2001, through the date of the filing of the bankruptcy petition [December 22, 2005]. It alleges that these payments were fraudulent and/or preferential and may be recovered by the Trustee.

The Defendant filed an answer to the complaint on September 14, 2007, in which he asserts that any transfers received by him were outside the applicable limitations period, and denies that the Trustee is entitled to relief. He demands a jury trial to try his case. Dkt. No. 7. After the answer was filed, there followed prolonged attempts at settlement. The Trustee eventually filed his motion for summary judgment on April 15, 2009. Dkt. No. 10. The Defendant filed his response on July 30, 2009, and a second response and motion to dismiss or in the alternative, for summary judgment on March 3, 2011. Dkt. Nos. 11, 13, 15. The undersigned bankruptcy judge was assigned to this proceeding on April 1, 2011. Dkt. No. 17. The Trustee filed a response to the Defendant's motion to dismiss and for summary judgment on April 4, 2011, and requested that the court set a hearing on his motion for summary judgment on May 11, 2011. Dkt. Nos. 19, 20, 21. I heard oral argument on June 23, 2011, following which I asked the parties to prepare post-hearing briefs on three issues:

1. The applicable reach-back period under section 548(a)(1)(A) for this proceeding.

2. The preclusive effect, if any, of the Debtor's guilty plea to establish fraudulent intent with respect to the transfers the Trustee seeks to recover.

3. The standard for determining good faith for purposes of section 548(c).

As I was drafting the Post-Hearing Briefing Order, I received notice that the Supreme Court had issued its opinion in *Stern v. Marshall*, ____ U.S. ____, 131 S. Ct. 2594 (June 23, 2011). As a result, I added a fourth issue to those that should be briefed by the parties:

4. Whether and how the Supreme Court's decision in *Stern v. Marshall* impacts the authority of the bankruptcy court to enter a final order in this case.

The parties completed the filing of their post-hearing briefs, responses, and replies on August 12, 2011.

II.

The Defendant takes the position that, as the result of *Stern v. Marshall,* "a bankruptcy court has no authority to decide a matter that could have been brought if the bankruptcy case had never been filed." Post-Hearing Memorandum of Law of Defendant Charles Kelly, Sr. on Cross Motions for Summary Judgment. Dkt. No. 45, p. 24. The Defendant concludes from this that the bankruptcy court is without authority to entertain claims brought pursuant to section 544 of the Bankruptcy Code, which permits the trustee to "avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of . . . title [11] or that is not allowable only under section 502(e) of . . . title [11]. 11 U.S.C. § 544(b)(1). The effect of this statute is to permit the trustee in bankruptcy to avoid for the benefit of the estate (rather than for the benefit of a single creditor) transfers made within the applicable reach-back period under state law, but beyond the reach-back period for a similar cause of action provided by federal bankruptcy law at section 548(1).[1]

The Defendant argues that the bankruptcy court is without authority to hear any cause of action brought pursuant to section 544(b)(1). Further, the Defendant asserts that while the bankruptcy court may have authority to hear and determine the section 548 claims, the interests of

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[1] The reach-back period under the Bankruptcy Code was extended from one year to two years as the result of the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). The parties have agreed that the prior, one year reach-back period applies with respect to this proceeding because the main bankruptcy case was filed on December 22, 2005, before the effective date of this particular amendment. *See* Pub. L. 109-8, 119 Stat. 23 § 1406(b)(2). The applicable reach-back period under Tennessee law is four years. Tenn. Code Ann. § 66-3-310.

judicial economy and convenience, and the risk of inconsistent, overlapping decisions dictates that the bankruptcy court abstain from hearing those matters to permit the Defendant to seek withdrawal of the reference by the district court. Finally, the Defendant asserts that the Trustee has failed to demonstrate that the transfers to the Defendant were fraudulent as a matter of law, and thus, that he is entitled to summary judgment. Dkt. No. 45, p. 24.

The Trustee responds that the facts and circumstances of this case are distinguishable from those in *Stern v. Marshall*, and thus, the bankruptcy court *does* have authority to entertain state fraudulent transfer claims as well as federal fraudulent transfer claims. The Trustee asserts that this is so because the claims that he is pursuing "arise under" the Bankruptcy Code by virtue of sections 548 and 544(b), even though section 544(b)(2) incorporates state law. The Trustee asserts that his complaint initiated a core proceeding and that the Defendant has admitted that it is a core proceeding; thus, the Trustee concludes, the bankruptcy court has authority to hear and determine these claims. Dkt. No. 48, p.4.

The Trustee filed a consent to have the jury trial of this adversary proceeding heard by a bankruptcy judge. Bankr. Dkt. No. 1316. The Defendant did not file a consent within the time set by this bankruptcy judge, July 29, 2011. *See* 28 U.S.C. § 158(e); Fed. R. Bankr. P. 9015(b).

III.

Before undertaking any consideration of the merits of the parties' motions, I must determine what authority the bankruptcy court has with respect to this dispute. This requires a careful reading of the Supreme Court's decision in *Stern v. Marshall* to ascertain the scope of the bankruptcy court's authority. The question before the Court in *Stern* was whether an Article I bankruptcy judge may hear and determine a state law counterclaim filed by a debtor in response to a proof of claim filed against the bankruptcy estate. Section 157(b)(2)(C) expressly provides that "counterclaims by the estate against persons filing claims against the estate" are "core proceedings" which bankruptcy judges may hear and determine, i.e., enter a final order or judgment subject only to appellate review. 28 U.S.C. § 157(b)(2)(C). Nevertheless, the Supreme Court held that although the bankruptcy courts have express *statutory* authority to enter judgment on a debtor's counterclaim, they lack *constitutional* authority to do so. 131 S. Ct. at 2603-20. This court must determine the effect of that holding upon this complaint to recover fraudulent conveyances and preferential transfers.

Just as counterclaims filed in response to proofs of claim are core proceedings, proceedings to determine, avoid, or recover fraudulent conveyances and preferential transfers are among the proceedings listed as "core proceedings" by Congress. 28 U.S.C. § 157(b)(2)(F) and (H). There is no question that the bankruptcy courts have *statutory* authority to hear and determine the types of actions which are the subject of the complaint in this adversary proceeding. 28 U.S.C. § 157(b)(1).[2] Further, preferential transfers in all instances and fraudulent conveyances in some instances may be recovered pursuant to federal bankruptcy law. *See* 11 U.S.C. §§ 547 and 548. As the result of the Court's decision in *Stern*, however, the fact that Congress has designated a particular type of proceeding as "core" is insufficient. The bankruptcy courts cannot rely upon the core/non-core distinction to determine whether they may hear and finally determine a particular cause of action. Instead they must determine whether the statutory authority delegated to them by Congress is within the constitutional guidelines provided by *Stern*. This is the analysis that must be undertaken in this

[2] "Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title."

case before there can be any consideration of the merits of the complaint pursuant to the motions for summary judgment.

A.

The Supreme Court determined in *Stern* that the division of actions between "core" or "non-core" provided by Congress at section 157(b)(2) does not accurately reflect the constitutional limitation upon the exercise of the judicial power of the United States. Specifically, the Court decided that bankruptcy courts do not have constitutional authority to hear and determine at least one of the listed core proceedings, which raises the question whether there are other "core proceedings" that fall outside the bankruptcy court's constitutional authority. Although the Court indicated that its decision was a "narrow" one encompassing one "isolated instance," this court must determine the reasons for the Court's decision in order to decide whether the cause of action in *Stern* may meaningfully be distinguished from the causes of actions raised in this adversary proceeding.

The Supreme Court started its discussion of the constitutional question by recalling that the Constitution vests the judicial power of the United States in one supreme court and such inferior courts as Congress may from time to time establish. The judges of the constitutional courts hold their offices during good behavior and receive compensation that cannot be diminished during their tenure. Const. art. III, § 1. The Court next recalled that under its prior decisions the judicial power of the United States cannot be shared with either of the other branches of the government, both to protect each branch of government from incursion by the others and to protect individuals from prior abuses. As a result, said the Court, Congress may not withdraw from the judiciary any matter that was the subject of a suit at common law, or in equity, or admiralty:

> When a suit is made of "the stuff of the traditional actions at common law tried at the courts at Westminster in 1789," and is brought within the bounds of federal

> jurisdiction, the responsibility for deciding that suit rests with Article III judges in Article III courts. The Constitution assigns that job – resolution of "the mundane as well as the glamorous, matters of common law and statute as well as constitutional law, issues of fact as well as issues of law" – to the Judiciary.

Stern, 131 S. Ct. at 2609 (internal citations omitted).

The Court next recalled the history of *Northern Pipeline* in which it was called upon to determine whether bankruptcy judges appointed by the President and confirmed by the Senate, but lacking the tenure and salary guarantees of Article III, could constitutionally determine a state law contract claim against an entity that was not otherwise part of the bankruptcy proceedings. The Court concluded that they could not. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 52, 87, 102 S. Ct. 2858 (1982) (plurality opinion); *Id.* at 91 (Rehnquist, J., concurring in judgment). As the Court explains in *Stern*, a plurality of the justices in *Northern Pipeline* agreed that cases involving "public rights" may be assigned to "legislative" courts for decision, but limited the public rights exception to matters arising between an individual and the government in connection with the performance of constitutional functions of the executive or legislature. A majority of the court could not agree on the full scope of the public rights exception, but did agree that it did not extend to the contract claim under consideration. A majority in *Northern Pipeline* also rejected the argument that the bankruptcy court's exercise of jurisdiction was constitutional because the bankruptcy judge was acting merely as an adjunct of the district court or court of appeals. *Stern*, 131 S. Ct. at 2609-10.

After *Northern Pipeline*, Congress amended the United States Code to provide that bankruptcy judges would be appointed by the courts of appeals for the districts in which their courts were located. Bankruptcy Amendments and Federal Judgeship Act (BAFJA) of 1984, Pub. L. 98-

353, § 104, 98 Stat. 333, 336 (July 10, 1984) codified at 28 U.S.C. § 152(a)(1). Congress also provided for the constitution of bankruptcy courts as units of the district courts:

> In each judicial district, the bankruptcy judges in regular active service shall constitute a unit of the district court to be known as the bankruptcy court for that district. Each bankruptcy judge, as a judicial officer of the district court, may exercise the authority conferred under this chapter with respect to any action, suit, or proceeding and may preside alone and hold a regular or special session of the court, except as otherwise provided by law or by rule or order of the district court.

28 U.S.C. § 151. Original and exclusive jurisdiction of bankruptcy cases was conferred upon the district courts. 28 U.S.C. § 1334(a). Original, but not exclusive, jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11, was also conferred upon the district courts. 28 U.S.C. § 1334(b). The district courts were given jurisdiction of all property, wherever located, of the debtor as of the commencement of the case and of property of the estate. 28 U.S.C. § 1334(e)(1). Bankruptcy *jurisdiction* was conferred upon the district courts. The district judges were then permitted to delegate *authority* to act with respect to bankruptcy cases and proceedings to the bankruptcy judges for the district. 28 U.S.C. § 157(a). The permissible delegation of authority was divided in two: the district courts were permitted to delegate full authority to hear and determine subject only to appellate review all cases under title 11 and all core proceedings arising under title 11 or in a case under title 11. The district courts were permitted to delegate only limited authority to the bankruptcy courts with respect to non-core proceedings related to a bankruptcy case. For those proceedings, the district courts were permitted to delegate authority to the bankruptcy judges to hear the proceedings and submit proposed findings of fact and conclusions of law to the district courts, which then conduct a *de novo* review of those portions objected to by any party. 28 U.S.C. § 157(c)(1). With the consent of the parties, the bankruptcy judges were permitted to hear and determine proceedings related to a bankruptcy case and to enter

appropriate orders and judgments, subject only to appellate review. 28 U.S.C. § 157(c)(2). Pursuant to these provisions, all of the district courts in the United States issued orders of reference to the bankruptcy courts, granting the fullest possible authority to deal with bankruptcy matters and proceedings. *See, e.g., In re Jurisdiction and Proceedings Under the Bankruptcy Amendments Act of 1984,* Misc. No. 81-30 (W.D. Tenn. July 10, 1984).

This is the system that prevails today. Under this system, the *Stern* Court noted, with respect to core proceedings, the bankruptcy courts exercise the same powers that they enjoyed before the amendment of the Act: they resolve all matters of fact and law; they issue final judgments that are binding and enforceable even in the absence of an appeal; and the district courts review these decisions only under the limited appellate standards, which give special deference to the bankruptcy judges' findings of fact. *Id.* at 2610-11. The petitioner and the dissent in *Stern* argued that the bankruptcy court's entry of a final judgment on the petitioner's state law claim was constitutional notwithstanding the similarities between the bankruptcy courts under the 1978 Act and those exercising core jurisdiction under the 1984 Act. The Court disagreed, finding it "clear that the Bankruptcy Court in this case exercised the 'judicial power of the United States' in purporting to resolve and enter final judgment on a state common law claim, just as the court did in *Northern Pipeline.*" *Id.* at 2611. The Court was not persuaded that the petitioner's counterclaim was excepted by the fact that it was filed in response to a proof of claim filed against the bankruptcy estate. The petitioner's claim was a "state law action independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor's proof of claim." *Id.* Nor was the Court convinced that the bankruptcy courts under the 1984 Act are mere adjuncts of Article III courts, any more than were the bankruptcy judges under the 1978 Act: "The judicial powers the courts exercise in cases such as this remain the same, and a court exercising such broad powers is no mere adjunct of anyone." *Id.*

The Court thus drew three conclusions:

1. A non-Article III bankruptcy judge cannot constitutionally exercise the judicial power of the United States.

2. The judicial power of the United States is required to resolve causes of action unless an exception, such as the "public rights exception," applies.

3. The judicial powers that are necessarily exercised by a judge in resolving state common law claims go beyond those that can be exercised by a mere adjunct of an Article III judge.

The first conclusion provides the general rule: non-Article III appointees cannot constitutionally exercise the judicial power of the United States. The second conclusion delineates those disputes that require the exercise of the judicial power of the United States. The third conclusion indicates that the broad powers given to bankruptcy judges under the 1984 Act – to resolve and enter final judgments on state common law counterclaims – go beyond those that can be exercised by an adjunct to the district court.

B.

The Court turned next to a discussion of what sorts of claims can be termed a matter of "public right" that can be decided outside the judicial branch. The Court provided a history of the public rights exception beginning with *Murray's Lessee v. Hoboken Land & Improvement Co.*, 59 U.S. 272, 18 How. 272, 15 L. Ed. 372 (1856), in which the plaintiff objected to the Treasury Department's sale of land to satisfy a debt owed to it by one of its customs collectors resulting from his failure to remit payments collected on behalf of the federal government to the Treasury. The plaintiff claimed an interest in the same parcel of land, and argued that the actions of the Treasury in calculating the deficiency owed by the customs agent and selling the property were judicial acts that could only be undertaken by the judiciary, not the executive branch. In that case, the Court agreed that Congress cannot "withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." *Id.* at 284, quoted in *Stern* at 2609, 2612. But the Court recognized that "[a]t the same time there are matters, involving public rights, which may be presented in such form that the judicial power is capable of acting on them, and which are susceptible of judicial determination, but which congress may or may not bring within the cognizance of the courts of the United States, as it deems proper." *Id.* The plaintiff's complaint in *Murray's Lessee* was one of public right, concluded the Court, because it could only be brought if the federal government chose to waive its sovereign immunity. *Id.* The *Stern* Court summarized the prior decision: "The point of *Murray's Lessee* was simply that Congress may set the terms of adjudicating a suit when the suit could not otherwise proceed at all." *Id.* Subsequent cases contrasted cases of public right – between the government and persons subject to its authority in connection with the performance of its executive or legislative functions – and private rights – those concerning the liability of one individual to another. The Court has not limited the exception to actions involving the government as a party, but:

> has continued ... to limit the exception to cases in which the claim at issue derives from a federal regulatory scheme, or in which resolution of the claim by an expert government agency is deemed essential to a limited regulatory objective within the agency's authority. In other words, it is still the case that what makes a right "public" rather than private is that the right is integrally related to particular federal government action.

Id. at 2613 (citation omitted). The Court then gives a number of examples from its prior decisions to illustrate the public rights/private rights distinction.

Of particular note is the Court's decision in *Granfinanciera*, *S.A. v. Nordberg,* 492 U.S. 33, 109 S. Ct. 2782, 106 L. Ed. (1989), the only case in which the Court has considered the public rights/private rights distinction in the context of bankruptcy since its decision in *Northern Pipeline*. As characterized in *Stern*, there the Court "rejected a bankruptcy trustee's argument that a fraudulent conveyance action filed on behalf of the bankruptcy estate against a non-creditor in a bankruptcy proceeding fell within the 'public rights' exception." *Stern*, 131 S. Ct. at 2614. In *Granfinanciera*, the Court said:

> [i]f a statutory right is not closely intertwined with a federal regulatory program Congress has power to enact, and if that right neither belongs to nor exists against the Federal Government, then it must be adjudicated by an Article III court.

Granfinanciera, 492 U.S. at 54-55, 109 S. Ct. 2782, quoted in *Stern*, 131 S. Ct. at 2614. The Court continued:

> Although the issue admits of some debate, **a bankruptcy trustee's right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2) seems to us more accurately characterized as a private rather than a public right** as we have used those terms in our Article III decisions. In *Northern Pipeline* the plurality noted that the restructuring of debtor-creditor relations in bankruptcy "may well be a 'public right.'" But the plurality also emphasized that state-law causes of action for breach of contract or warranty are paradigmatic private rights, even when asserted by an insolvent corporation in the midst of Chapter 11 reorganization proceedings.... **There can be little doubt that fraudulent conveyance actions by bankruptcy trustees –** suits which we said in *Schoenthal v. Irving Trust Co.*, 287 U.S., at 94-95, 53 S. Ct., at 51 (citation omitted), "constitute no part of the proceedings in bankruptcy but concern controversies arising out of it" **– are quintessentially suits at common law that more nearly resemble state-law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res.** They therefore appear **matters of private rather than public right**.

Id., 492 U.S. at 55-56, 109 S. Ct. at 2797-98 (emphasis added; some internal citations omitted), partially quoted in *Stern,* 131 S. Ct. at 2614.

The *Stern* Court then goes on to compare this formulation to the petitioner's counterclaim:

> [Petitioner]'s counterclaim – like the fraudulent conveyance claim at issue in *Granfinanciera* – does not fall within any of the varied formulations of the public rights exception in this Court's cases. It is not a matter that can be pursued only by [the] grace of the other branches, as in *Murray's Lessee*, or one that "historically could have been determined exclusively by" those branches. The claim is instead one under state common law between two private parties. It does not "depend[] on the will of congress." Congress has nothing to do with it.

Stern, 131 S. Ct. at 2614. The Court continues with other examples from its prior decisions, in each case distinguishing the petitioner's counterclaim as a private rather than a public right. It concludes:

> What is plain here is that **this case involves the most prototypical exercise of judicial power: the entry of a final, binding judgment *by a court* with broad substantive jurisdiction, on a common law cause of action**, when the action neither derives from nor depends upon any agency regulatory regime. **If such an exercise of judicial power may nonetheless be taken from the Article III Judiciary simply by deeming it part of some amorphous "public right," then Article III would be transformed from the guardian of individual liberty and separation of powers we have long recognized into mere wishful thinking.**

Id. at 2615 (emphasis added). The Court's conclusion is clear: a judge that enters a final, binding judgment on a common law cause of action that is not derived from nor dependent upon a federal regulatory regime is exercising judicial power.

C.

The Supreme Court then took up the petitioner's argument that the bankruptcy court's final judgment was constitutional because the bankruptcy courts under the 1984 Act are mere adjuncts of the district court. It noted that it had rejected a similar argument in *Northern Pipeline*, and that its reasoning there remains sound. The bankruptcy courts under the 1984 Act are permitted to exercise judicial power over state common law causes of action, such as the petitioner's counterclaim. The new courts, like the old, are not confined to making "only specialized, narrowly confined factual determinations regarding a particularized area of law," nor are they limited to "statutorily channeled fact-finding functions." *Stern*, 131 S. Ct. at 2618. Under the 1984 Act, the authority – and responsibility – to make an informed, final determination remains with the bankruptcy judge, not the district judge. *Id.* at 2619, citing *Northern Pipeline*, 458 U.S. at 81. Under these circumstances, said the Court, the bankruptcy courts are no more adjuncts of the district courts than they are adjuncts of the courts of appeals. Moreover, the Court said that even if it were to accept the characterization of the dissent that bankruptcy judges are the functional equivalents of law clerks or judicial assistants, this would only confirm its opinion that such persons should not be entering final judgments. Finally, the Court said that it does not matter how the bankruptcy judges are appointed, so long as they do not enjoy the independence guaranteed by Article III, they may not exercise the judicial power of the United States. *Id.*

D.

I turn now to the application of the Court's decision to the proceeding before this bankruptcy court. It involves a complaint to recover allegedly fraudulent and preferential transfers from a defendant who was one of the petitioning creditors who commenced the bankruptcy case, but who has not filed a proof of claim against the bankruptcy estate, has demanded a jury trial in this proceeding, and has not consented to the bankruptcy judge conducting a jury trial. The question before the court is not whether subject matter jurisdiction is present, but rather whether delegation to the bankruptcy court of authority to hear and finally determine these causes of action is constitutionally permissible. *See, e.g., In re Fairchild Corp.*, 452 B.R. 525, n.14 (Bankr. D. Del. 2011) ("The issue in *Stern v. Marshall* was when, under the United States Constitution, the bankruptcy court could enter a final judgment as opposed to proposed findings of fact and conclusions of law in a case where subject matter jurisdiction existed under 28 U.S.C. § 1334(a).").

1.

Count I of the Trustee's complaint in this case asks the court to avoid and recover alleged fraudulent conveyances both under the Bankruptcy Code and, by incorporation, under applicable state law, from an individual who has not filed a proof of claim against the bankruptcy estate. Both parties assume that a distinction can be drawn between the alleged conveyances that may be avoided under section 548(a)(1) of the Bankruptcy Code and those that may only be avoided under section 544(b) of the Bankruptcy Code. *Granfinanciera* does not make that distinction, however. *Granfinanciera* involved a suit by a Chapter 11 trustee filed in district court to recover allegedly fraudulent conveyances under section 548(a)(1) and (a)(2) and 550(b). 492 U.S., at 36, 109 S. Ct., at 2787. The district court referred the proceedings to the bankruptcy court. The defendants requested a "trial by jury on all issues so triable." *Id.*, at 37. The bankruptcy judge denied the request for jury trial, deeming the suit to recover a fraudulent conveyance "a core action that originally, under the English common law, as I understand it, was a non-jury issue." *Id.* quoting App. to Pet. for Cert. 24. After a bench trial, the bankruptcy judge dismissed with prejudice the actual fraud claim, but granted substantial judgments on the constructive fraud claims. The district court affirmed without discussing the demand for jury trial. The Court of Appeals for the Eleventh Circuit also affirmed, finding that Congress may convert a legal right into an equitable claim displacing any right to jury trial, and that it had done so with respect to fraudulent conveyance actions by designating them core proceedings in bankruptcy. *Id.*

The claim to jury trial in *Granfinanciera* rested on the Seventh Amendment alone. *Id.* at 40. Thus the Court was called upon to determine whether the fraudulent conveyance claim, a core bankruptcy proceeding under the Bankruptcy Code, was within those suits at common law for which the right to jury trial was preserved by the Seventh Amendment. It began its analysis, recalling that it had consistently interpreted “suits at common law” to mean “suits in which *legal* rights were to be ascertained and determined, in contradistinction to those where equitable rights alone were recognized, and equitable remedies were administered,” and that the Amendment preserves the right to jury trial not only as it existed in 1791, but also as it applies to actions brought “to enforce statutory rights that are analogous to common-law causes of action ordinarily decided in English law courts in the late 18th century, as opposed to those customarily heard by courts of equity or admiralty.” *Id.*, at 41-42.

Significantly for present purposes, the Court divided its inquiry into four steps: (1) whether the statutory action is analogous to an action brought in England prior to the merger of law and equity; (2) whether the remedy sought is legal or equitable in nature; (3) if these two inquiries indicate that a right to jury trial exists under the Seventh Amendment, whether Congress may assign the resolution of the relevant claim to a non-Article III adjudicative body that does not use a jury as factfinder; and (4) whether it has in fact done so. *Id.* The Court found in the affirmative with respect to the first two inquiries. It concluded that a petitioner would have had to bring an action to recover an alleged fraudulent conveyance of a determinate sum of money at law in 18th century England, and that an action sounding in tort or for money had and received was the appropriate and adequate remedy at law.

The Court then turned to consideration of the recovery of fraudulent conveyance prior to the passage of the Bankruptcy Reform Act of 1978. As indicated above, those suits constituted no part of the proceedings in bankruptcy prior to 1978. Although related to bankruptcy proceedings, they required separate, plenary suits to which the Seventh Amendment applied. *Id.* at 49-50. The Court carefully delineated the issue before it:

> We are not obliged to decide today whether bankruptcy courts may conduct jury trials in fraudulent conveyance suits brought by a trustee against a person who has not entered a claim against the estate .... Nor need we decide whether, if Congress has authorized bankruptcy courts to hold jury trials in such actions, that authorization comports with Article III when non-Article III judges preside over the actions subject to review in, or withdrawal by, the district courts. We also need not consider whether jury trials conducted by a bankruptcy court would satisfy the Seventh Amendment's command that "no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law," given that district courts may presently set aside clearly erroneous factual findings by bankruptcy courts.... The sole issue before us is whether the Seventh Amendment confers on petitioners a right to a jury trial in the face of Congress' decision to allow a non-Article III tribunal to adjudicate the claims against them.

Id. at 50. The question that the Court next took up was whether, given its determination that fraudulent conveyance claims were tried to a jury at common law, Congress could avoid this result by assigning the cause of action to an administrative agency. Relying upon its prior decision in *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n,* 430 U.S. 442, 97 S. Ct. 1261 (1977), the Court said that Congress may only deny trials by jury in cases where "public rights" are litigated: "Our prior cases support administrative factfinding in only those situations involving 'public rights,' e.g., where the Government is involved in its sovereign capacity under an otherwise valid statute creating enforceable public rights. Wholly private tort, contract, and property cases, as well as a vast range of other cases, are not at all implicated." *Id.* at 51, quoting *Atlas Roofing*, 430 U.S., at 458, 97 S. Ct., at 1270. After further discussion of the inability of Congress to "conjure away" the right to jury trial, the Court concludes:

> Our case law makes plain ... that the class of "public rights" whose adjudication Congress may assign to administrative agencies or courts of equity sitting without juries is more expansive than *Atlas Roofing*'s discussion suggests. Indeed, our decisions point to the conclusion that, if a statutory cause of action is legal in nature, the question whether the Seventh Amendment permits Congress to assign its adjudication to a tribunal that does not employ juries as factfinders requires the same answer as the question whether Article III allows Congress to assign adjudication of that cause of action to a non-Article III tribunal. For if a statutory cause of action,

> such as respondent's right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2), is not a "public right" for Article III purposes, then Congress may not assign its adjudication to a specialized non-Article III court lacking "the essential attributes of judicial power."

Id. at 53. Although the Court was not called upon to decide the particular issue before this court, it seems inescapable that if a cause of action is legal in nature, and it is a matter of private rather than public right, the Seventh Amendment right to jury trial attaches to it and it must be heard and decided by an Article III court. In *Granfinanciera*, the Supreme Court decided that actions to recover fraudulent conveyances under section 548(a)(2) are more accurately characterized as matters of private rather than public right. *Id.* at 55. Fraudulent conveyance actions were not part of the proceedings in bankruptcy prior to 1978 and they "are quintessentially suits at common law that more nearly resemble state-law contract claims brought by a bankruptcy corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res." *Id.* at 56. If this is true concerning constructive fraud claims under section 548(a)(2), I see no reason why it would not also be true with respect to actual fraud claims under section 548(a)(1). Section 548(a)(1) merely codifies the action for fraudulent conveyance that has been part of the common law since at least *Twyne's Case*, 3 Coke 80b, 76 Eng. Rep. 809 (Star Chamber, 1601). Under *Granfinanciera* it makes no difference that a portion of the claim is brought under section 548(a)(2) of the Bankruptcy Code and another portion under section 544(b), which incorporates state law. So long as a defendant has not subjected himself to the claims adjudication process by filing a proof of claim, the fraudulent conveyance action does not arise as part of the claims allowance process. It is a matter of private right that cannot constitutionally be determined without a jury if demanded nor by a non-Article III tribunal.

2.

Count II of the complaint seeks to recover the same transfers that are the subject of Count I as preferential transfers pursuant to section 547(b) of the Bankruptcy Code. The recovery of preferential transfers may in some cases arise as part of the claims allowance process in bankruptcy. Prior to 1978, in those cases in which a creditor was said to have received a preferential transfer in the period preceding bankruptcy, the Court permitted the bankruptcy referee[3] to resolve the question of the voidable preference in the context of ruling on the creditor's proof of claim. *Katchen v. Landy*, 382 U.S. 323, 329-30, 332-33, and n. 9, 334, 86 S. Ct. 467 (1966). The lesson there was that if an issue arises and necessarily must be determined as part of the claims allowance process, the bankruptcy court may proceed. When it does, there will be nothing left for an Article III court to determine. In that connection, the Court said, "he who invokes the aid of the bankruptcy court by offering a proof of claim and demanding its allowance must abide by the consequences of that procedure." *Id.* at 333, n. 9, 86 S. Ct. 467, quoted in *Stern*, 131 S. Ct. at 2616. In *Katchen* the Court gave no opinion concerning whether a bankruptcy referee would have "summary jurisdiction to adjudicate a demand by the trustee for affirmative relief, all of the substantial factual and legal bases for which ha[d] not been disposed of in passing on objections to the [creditor's proof of] claim." *Katchen*, 382 U.S. at 333, n. 9, 86 S. Ct. 467, quoted in *Stern*, 131 S. Ct. at 2617.

In its *per curiam* opinion in *Lagenkamp v. Culp*, the Court explained that a creditor who submitted a proof of claim against a bankruptcy estate and was later sued by the trustee to recover allegedly preferential transfers was not entitled to a jury trial under the Seventh Amendment on the

[3] Bankruptcy referees came to be called judges in 1973. *See* Elizabeth Warren and Jay Lawrence Westbrook, *The Law of Debtor and Creditors* 800 (6th ed. 2009).

preference claim. 498 U.S. 42, 45, 111 S. Ct. 330 (1990). If the creditor has not filed a proof of claim, however:

> [T]he trustee can recover allegedly preferential transfers only by filing what amounts to a legal action to recover a monetary transfer. In those circumstances the preference defendant is entitled to a jury trial.

498 U.S. at 45, 111 S. Ct. at 331, quoting *Granfinanciera*, 492 U.S. at 58-59, 109 S. Ct. at 2799.

The defendant who is entitled to trial by jury is also entitled to trial by an Article III court. The Court in *Stern* seems to suggest that a distinction can be drawn between fraudulent conveyance actions, which arise under state common law, and preferential transfer actions, which are created by federal bankruptcy law (s*ee Stern*, 131 S. Ct. at 2618), but the Court in *Granfinaciera* made no such distinction, and in fact noted that actions to recover preferential transfers or fraudulent conveyances were often brought at law in 18th century England. *Granfinaciera*, 492 U.S. at 43. The relevant distinction announced in *Granfinanciera* was that between actions that seek "to augment the bankruptcy estate," which are matters of private right, and those that seek a "pro rata share of the bankruptcy res," which may or may not be matters of public right. *Granfinanciera*, 492 U.S. at 56, 109 S. Ct. at 2782. While not clearly adopting this distinction, the Court in *Stern* indicated that actions that properly may be assigned to the bankruptcy courts for final decision are those that stem from the bankruptcy itself or would necessarily be resolved in the claims allowance process. *Stern*, 131 S. Ct. at 2618. Using this test, when a creditor who has not filed a proof of claim is sued by the bankruptcy trustee to recover a preferential transfer, it is a matter of private right, which, as we have seen, requires the exercise of the judicial power of the United States, a power that cannot be exercised by a non-Article III judge. This division appears fairly distinct and relatively easy to apply. If a civil proceeding has the primary purpose of augmenting the bankruptcy estate, rather than resolving claims against the estate, it is a matter of private right that must be determined by an Article III court.

E.

The court must consider whether the fact that the Defendant was one of the petitioning creditors changes the analysis of the public/private rights distinction. *Stern* suggests not. Even though the counterclaim under consideration in *Stern* was raised *in response to* a proof of claim, the counterclaim required adjudication of facts that were not necessary to the claims adjudication process, and indeed sought affirmative relief beyond mere set off against the proof of claim. The Trustee in this adversary proceeding is seeking affirmative relief against the Defendant for the benefit of the bankruptcy estate. We have seen that certain rights arise in connection with such a proceeding, including the right to have the matter heard and determined by an Article III court. Is this a right that may be waived by a party to an adversary proceeding in bankruptcy? The *Stern* Court seems to indicate that it may not when it rejects the argument that the right to have the counterclaim in that case heard by an Article III court was waived when the counter-defendant filed his proof of claim. Relying on *Granfinanciera*, the Court distinguished prior decisions noting that in bankruptcy proceedings "creditors lack an alternative forum to the bankruptcy court in which to pursue their claims." *Stern*, 131 S. Ct., at 2614-15, quoting *Granfinanciera*, 492 U.S. at 59, n. 14, 109 S. Ct. 2782. The Court seems to suggest that the requirement of a hearing and determination by an Article III court is *jurisdictional*. That is, that there is a constitutional limit to powers that may be conferred by Congress upon a non-Article III tribunal, and that this constitutional limit had been exceeded in the 1984 amendments to the Bankruptcy Code:

> We deal here not with an agency but with a court, with substantive jurisdiction reaching any area of the *corpus juris*. This is not a situation in which Congress

> devised an "expert and inexpensive method for dealing with a class of questions of fact which are particularly suited to examination and determination by an administrative agency specially assigned to that task." The "experts" in the federal system at resolving common law counterclaims such as [the petitioner's] are the Article III courts, and it is with those courts that her claim must stay.

Stern, 131 S. Ct. at 2615 (internal citations omitted).

Bankruptcy Judge Jeffrey R. Hughes has issued an exhaustive opinion in which he discusses the reach of *Stern*. *In re Teleservices Group, Inc.*, ___B.R.___, 2011 WL 3610050 (Bankr. W.D. Mich. August 17, 2011). He suggests that the distinction drawn is one of due process, and that due process constrains Congress from depriving a person of his life or liberty without that decision being made by someone with the independence guaranteed by Article III of the Constitution. *Id.* at *13. This approach seems to reach the same result as *Granfinanciera's* distinction between actions to augment the bankruptcy estate and other actions undertaken in aid of the administration of the bankruptcy estate.

Other bankruptcy judges believe that *Stern* is to be limited solely to the particular core proceeding at issue there: a counterclaim by the estate against a person filing a claim against the estate. *See, e.g., Tribble v. Wells Fargo Bank, N.A. (In re Hudson)*, ___B.R.___, 2011 WL 3583278 (Bankr. W.D. Mich. Aug. 16, 2011) ("Except for the types of counterclaims addressed in *Stern v. Marshall*, a bankruptcy judge remains empowered to enter final orders in all core proceedings."); *In re Peacock*, ___B.R.___, 2011 WL 3874461 (Bankr. M.D. Fla. September 2, 2011) ("The narrow holding in *Stern*, as just described, does not impact a bankruptcy court's ability to enter a final judgment in any other type of core proceeding authorized under 28 U.S.C. § 157(b)(2). Similarly, *Stern* does not impact a bankruptcy court's ability to hear non-core matters under 28 U.S.C. §

157(c), albeit not decide them absent the parties' consent."). For the reasons cited in this report, I do not agree with the conclusion of these bankruptcy judges.

F.

Even were it possible for the Defendant to have waived his right to a final determination by an Article III court, he cannot be said to have done so by joining in the filing of the involuntary petition in this case. "[W]aiver is the intentional relinquishment or abandonment of a known right." *Days Inn Worldwide, Inc. v. Patel*, 445 F.3d 899, 905 (6th Cir. 2006), quoting *United States v. Osborne*, 402 F.3d 626, 630 (6th Cir. 2005). While the filing of a proof of claim may invoke the claims resolution process in bankruptcy, the filing of an involuntary petition does not do so. In no way can a petitioner be charged with anticipating all outcomes of the filing, such that his act may be interpreted as the knowing relinquishment of rights that might arise at a stage much later in the involuntary bankruptcy case.

G.

The Trustee argues that the bankruptcy court may hear and determine his claims because they are different from the counterclaim in *Stern*. The Trustee argues that his claims are for recovery of fraudulent transfers, which are created by the Bankruptcy Code. Further, he argues that his claims against the Defendant are "'integral to the restructuring of the debtor-creditor relationship' . . . as their goal is to recoup fraudulent transfers in order to collect and then divide those funds evenly among all those whom the Debtor has defrauded." Trustee's Reply to Defendant's Post-Hearing Memorandum, Dkt. No. 48, p. 5 (citation to *Stern* omitted). The Trustee is correct in saying that his complaint is intended to augment the bankruptcy estate. It has no other purpose. As such, it is among those types of civil proceedings that traditionally required the filing of a separate suit at law and a plenary trial by an Article III court. Under the 1984 Act, Congress attempted to change this outcome by re-designating proceedings to recover fraudulent conveyances and preferential transfers as core proceedings that might be heard and finally determined by a bankruptcy judge. The Court in *Stern* held that this was a constitutionally impermissible encroachment upon the judicial branch. The mere fact that a civil proceeding arises under the bankruptcy laws does not determine which court has authority to hear and finally determine it. Original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11, is vested in the *district courts.* 28 U.S.C. § 1334(b). Because this jurisdiction is original *but not exclusive,* even those civil proceedings that may be commenced in the district court need not be commenced there; with relief from the automatic stay or abstention, they may be commenced in an appropriate state court. The bankruptcy courts, as units of the district courts, may only exercise federal bankruptcy jurisdiction pursuant to referral from the district courts, and then only within constitutional limits. The Trustee suggests that the constitutional defect in the referral of the present proceeding to the bankruptcy court may be overcome by the consent of the parties. Indeed, at least two bankruptcy judges have indicated that if matters designated "core" by Congress are found to be merely related to a bankruptcy case, the parties may nevertheless consent to the entry of a final judgment by the bankruptcy judge. *Teleservices*, 2011 WL 3610050, at *14 ("common sense suggests that if the parties before a district court may consent to binding arbitration as a form of alternative dispute resolution, then they certainly should be able to choose the bankruptcy judge as their arbiter..."); *In re Olde Prairie Block Owner, LLC,* ___B.R.___, 2011 WL 3792406 (Bankr. N.D. Ill. Aug. 25, 2011) (Although ... counterclaims [at issue] were core proceedings under the statute ..., under the Constitution for reasons discussed in *Stern*, they must be treated as non-core proceedings and are not subject to final adjudication by a Bankruptcy Judge *without consent of the parties*.") (emphasis added). I believe that as a general proposition this analysis is correct, but it does not apply to this proceeding in which the Defendant has not consented to trial by the bankruptcy court.

In *Stern* the Court rejected the argument that a creditor who had filed a proof of claim impliedly waived his right to have the counterclaim against him decided by an Article III court when resolution of the counterclaim was not required in the claims allowance process. *Stern*, 131 S. Ct., at 2615-16. In the present case, however, no proof of claim was filed by Kelly, and although Kelly admitted that this adversary proceeding is a core proceeding over which the bankruptcy court may enter final judgment (Answer, ¶ 1, Dkt. No.7), I have determined that the fact that these types of causes of action are described as core proceedings in the applicable statute, is not dispositive of the question of the bankruptcy court's authority to hear and finally determine them. Thus, in agreeing that the adversary proceeding is a core proceeding, the Defendant cannot be said to have intentionally relinquished a known right. Further, Kelly has demanded a jury trial and has not consented to the conduct of that trial by the bankruptcy court. As we have seen, the right to a jury trial necessarily implies the right to final determination by an Article III court. In failing to consent to the conduct of a jury trial by this bankruptcy court, the Defendant indicated his lack of consent to final decision by the bankruptcy court.

H.

The court has determined that the civil proceeding before it raises questions that may not be heard and finally determined by a non-Article III court. The Defendant has demanded a jury trial. If this adversary proceeding must be tried, the bankruptcy court recommends that the district court withdraw the reference. This does not mean, however, that the bankruptcy court is without authority to entertain the motions for summary judgement that are before it. Just as it can in "related to" bankruptcy proceedings, the bankruptcy court may prepare proposed findings of fact and conclusions of law leaving any final determination to the *de novo* review of the district court. *Stern*, 131 S. Ct., at 2620; *see* 28 U.S.C. § 157(c)(1). "Under a *de novo* standard of review, the reviewing court decides an issue independently of, and without deference to, the [bankruptcy judge's] determination." *Menninger v. Accred. Home Lenders (In re Morgeson)*, 371 B.R. 798, 800 (B.A.P. 6th Cir. 2007). Indeed the *Stern* Court indicated that it did not "think the removal of the counterclaims ... from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute; [it] agree[d] with the United States that the question presented [to it was] a 'narrow' one." *Stern*, 131 S. Ct. at 2620. The impact of *Stern* is that neither the bankruptcy court nor the parties may simply rely upon the list of core proceedings provided by Congress to determine whether a bankruptcy judge may *finally* determine a particular proceeding. Instead, the bankruptcy court must determine whether the proceeding is a matter of public or private right. Matters of private right may not be finally decided by a bankruptcy judge without the consent of the parties. A bankruptcy judge may, however, prepare proposed findings of fact and conclusions of law for *de novo* review by the Article III district judge.

IV.

This bankruptcy court now turns to a consideration of the motions for summary judgment filed by the parties. A motion for summary judgment may be granted 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), incorporated at Fed. R. Bankr. P. 7056. When cross motions for summary judgment are filed, the court must consider each motion in turn to determine whether it may be granted. *Westfield Ins. Co. v. Tech Dry, Inc*., 336 F.3d 503, 506 (6th Cir. 2003); *Taft Broadcasting Co. v. U.S.*, 929 F.2d 240, 248 (6th Cir. 1991).

A.

The Trustee asserts that he is entitled to summary judgment as to Count I of his complaint. He asserts that, as a matter of law, the Defendant received transfers from the Debtor that are avoidable and recoverable as fraudulent transfers under 11 U.S.C. § 548(a)(1)(A). Trustee's Motion for Summary Judgment, Dkt. No. 10, p. 2. At oral argument it became clear that the Trustee also seeks summary judgment on his claim that some or all of the transfers made by the Debtor to the Defendant may be recovered under applicable state law by virtue of 11 U.S.C. § 544(b). The Trustee's motion for summary judgment is silent with respect to Count II of the complaint, which alleges that the transfers to the Defendant were preferential transfers that may be avoided and recovered for the estate pursuant to 11 U.S.C. § 547(b).

The Defendant's motion seeks to dismiss the complaint in its entirety. The Defendant seeks summary judgment as to both counts of the complaint. He asserts that he is entitled to judgment as a matter of law.

B.

In order to recover any alleged preferential transfer under section 547 of the Bankruptcy Code, the Trustee must prove, among other things, that the Defendant received a transfer of an interest of the Debtor in property on or within 90 days before the date of the filing of the petition [December 22, 2005]. 11 U.S.C. § 547(b)(4)(A). The 90th day prior to the filing of the petition was September 23, 2005.

The Defendant admits receiving and negotiating the following checks from the Debtor:

Date	Check Number	Payor	Amount
05/30/03	4832	Ray Davis	7,000.00
05/30/03	4833	Ray Davis	14,000.00
05/07/04	3080	Ray Davis	5,000.00
05/21/04	3127	Ray Davis	10,000.00
12/03/04	6391	Ray Davis	3,750.00
12/17/04	6389	Ray Davis	6,250.00
03/11/05	4212	Ray Davis	3,125.00
03/15/05	4214	Ray Davis	3,125.00
03/18/05	4215	Ray Davis	1,875.00
			54,125.00

Defendant's Response to Request for Admissions, Ex. D. to Trustee's Motion for Summary Judgment, Dkt. No. 10. The Trustee has failed to demonstrate that the Defendant received any check from the Debtor on after September 23, 2005. The Trustee has failed to prove that the Defendant received any transfer of an interest of the Debtor during the preference period. The Defendant is entitled to summary judgment with respect to Count II of the complaint.

C.

In order for the Trustee to recover alleged fraudulent transfers under section 548(a)(1)(A) of the Bankruptcy Code, he must ultimately prove:

1. A transfer of an interest of the debtor in property, or an obligation incurred by the debtor,

2. That was made or incurred on or within 1 year[4] before the date of the filing of the petition,

3. That 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.

See 11 U.S.C. § 548(a)(1)(A). Transfers are protected from recovery to the extent that the transferee takes for value and in good faith. 11 U.S.C. § 548(c).

1.

The Trustee has satisfied the first element required to demonstrate a fraudulent conveyance under section 548(a)(1)(A): a transfer of an interest of the debtor in property.

2.

In order to satisfy the second element, the Trustee must show that transfers were made by the Debtor during the applicable reach-back period. The involuntary bankruptcy petition was filed on December 22, 2005. Transfers made on or after December 22, 2004, were made on or within one year prior to the filing of the petition. The last three checks, checks numbered 4212, 4214, 4215, in the aggregate amount of $8,125, represent transfers of the Debtor within one year prior to the filing of the petition. The Trustee has satisfied the second element required to establish a fraudulent transfer under the Bankruptcy Code.

3.

In order to satisfy the third element, the Trustee must prove that the Debtor made these transfers with the actual intent to hinder, delay or defraud creditors. In order to do this, the Trustee

[4] Although the reach-back period was amended to two years pursuant to BAPCPA, the parties agree that the prior one year reach-back period applies in this case.

relies upon the Debtor's Plea Agreement and Guilty Plea, which he asserts "conclusively establishes that the Debtor operated a Ponzi scheme from December 2001 to December 2005 with the actual intent to defraud his creditors." Trustee's Motion for Summary Judgment, Dkt. No. 10, p. 1. The Defendant denies that the Plea Agreement and Guilty Plea "conclusively establish" the Debtor's intent with respect to the transfers made to him. The Defendant argues that the Trustee has failed to establish the third element of his cause of action in the face of the Defendant's motion for summary judgment, and thus that he, the Defendant, is entitled to summary judgment on Count I of the complaint.

Neither the Defendant nor the Trustee was a party to the criminal court action in which the Debtor entered his Plea Agreement. The Trustee does not pursue a cause of action that belongs to the Debtor, but one that, by virtue of the Bankruptcy Code, may be brought for the benefit of all creditors of the bankruptcy estate. Outside of bankruptcy, a fraudulent transfer may only be recovered by a creditor of the transferor.

The Trustee attempts to preclude the relitigation of an issue in this bankruptcy proceeding that was decided in the prior criminal proceeding, but the Trustee articulates no theory to support his assertion that the Defendant may be "conclusively bound" by prior statements of the Debtor. "Issue preclusion ... bars subsequent relitigation of a fact or issue where that fact or issue was necessarily adjudicated in a prior cause of action and the same fact or issue is presented in a subsequent suit." *Dickson v. Countrywide Home Loans (In re Dickson)*, ___ F.3d___, 2011 WL 3768684, *4 (6th Cir. August 26, 2011), quoting *Cobbins v. Tenn. Dep't of Transp.*, 566 F.3d 582, 589 (6th Cir. 2009). In order for issue preclusion to apply, four requirements must be satisfied:

> (1) the precise issue must have been raised and actually litigated in the prior proceedings; (2) the determination of the issue must have been necessary to the

> outcome of the prior proceedings; (3) the prior proceedings must have resulted in a final judgment on the merits; and (4) the party against whom estoppel is sought must have had a full and fair opportunity to litigate the issue in the prior proceeding.

Id., quoting *Cobbins* at 589-90. Here, the issue of fraudulent intent was not actually litigated in the prior proceeding. Section 85 of the Restatement (Second) of Judgments provides for the preclusive effect of a criminal judgment in subsequent civil proceedings, but a comment indicates that the rule presupposes that the issue was actually litigated. The comment concludes that section 85 does not apply to a guilty plea "because the issue has not actually been litigated." *See Gray v. C.I.R.*, 708 F.2d 243, 247 (6th Cir. 1983) (Merritt, J., dissenting), quoting Restatement (Second) of Judgments § 85, comment b (1982). In this case, the party against whom estoppel is sought, i.e., Kelly, is not the party who entered the prior guilty plea. Kelly had no opportunity to participate in the prior criminal proceedings. As a result, Kelly is not estopped from relitigating the issue of "actual intent to hinder, delay or defraud creditors" in this bankruptcy proceeding.

Is the Guilty Plea admissible for some other purpose in this adversary proceeding? Motions for summary judgment must be supported by evidence that would be admissible at trial. Fed. R. Civ. P. 56(c)(2). The statements contained in the Plea Agreement, in which the Debtor agreed to plead guilty to Counts 1 and 2 of the Information filed in *United States v. Davis*, Cr. No. 1-07-10002 (WDTN), are hearsay, which is defined as "a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted." Fed. R. Ev. 801. Such statements are admissible, however, pursuant to one of the exceptions to the hearsay rule, Rule 803(22), which permits the admission of judgments of prior convictions whether or not the declarant is available to testify. *See In re Slatkin*, 310 B.R. 740, 744-45 (C.D. Cal. 2004), *aff'd*, 222 Fed. Appx. 545 (9th Cir. 2007) (plea agreement is admissible in fraudulent transfer suits arising out of a purported Ponzi scheme); *Scholes v. Lehmann*, 56 F.3d. 750, 762 (7th Cir. 1996) (same). The weight to be given to the evidence of conviction is left to the trier of fact. *See* Barry Russell, *Bankruptcy Evidence Manual*, 2010-2011 edition, 2 vols. (West 2010), § 803:35. The Plea Agreement is admissible evidence.

The Plea Agreement itself contains no factual statements. Ex. A to Trustee's Motion for Summary Judgment, Dkt. No. 10. Rather, it incorporates the language of the Information. The Information contains the following recitation of facts:

COUNT 1

1. From on or about 2001 and continuing to on or about October 2005 in the Western District of Tennessee, and elsewhere, the defendant CECIL RAY DAVIS did knowingly, willfully and unlawfully devise and intend to devise a scheme and artifice to defraud and to obtain money by means of false and fraudulent pretenses and representations from various victims. The scheme and artifice to defraud and obtain money by means of false and fraudulent pretenses, representations, and promises are as follows CECIL RAY DAVIS proclaimed himself a successful business owner with potential to make high profits to his victims, to obtain and attempt to obtain loans of approximately $2.5 million in monies and funds under their custody and control by falsely and fraudulently promising excessively high interest rates on the victims' loans.
2. It was further part of the scheme and artifice to defraud that from on or about 2001 until October 2005, CECIL RAY DAVIS set up a "Ponzi scheme" which is a fraudulent arrangement in which lenders or participants were attracted by the lure of exorbitant profits by CECIL RAY DAVIS making payments of seemingly large profits to early lenders from monies obtained from later lenders, rather than from "profits" or "commissions" earned by the underlying business ventures, thereby creating the illusion that a legitimate profit-making business opportunity existed. CECIL RAY DAVIS used these payments to early lenders to attract later lenders and to conceal the scheme to defraud. The very nature of the scheme dictated that it eventually would fail when the market for new lenders became saturated.
3. The scheme was conducted by CECIL RAY DAVIS individually and/or through solely owned corporations and/or through other business entities while insolvent or nearly insolvent during the period of time of this information.

4. It was further a part of the scheme and artifice to defraud that CECIL RAY DAVIS would promise high rates of interest to induce victims into making loans to him.
5. It was further part of the scheme and artifice to defraud that CECIL RAY DAVIS would make timely payments to initial lenders to solicit additional loans and new lenders. CECIL RAY DAVIS always tried to renegotiate loans before the loans' original due date.
6. It was further part of the scheme and artifice to defraud that CECIL RAY DAVIS had two methods to pay lenders. Some lenders received the payments on their loans via U.S. Mail until approximately June 2005. Other lenders were convinced to re-loan their principal and interest with Davis or one of his companies.
7. It was further part of the scheme and artifice to defraud that when some of the lenders asked about the nature of their loans, CECIL RAY DAVIS used the following explanations:

   a) He specialized in purchasing products from foreign countries for resale in the United States through his businesses names Five D Marketing, Davis Imports and Exports, and Old World Imports and Exports.

   b) He had a profitable vending machine business, when in reality, in some instances, he sold nonexisting vending machines to unsuspecting purchasers.

   c) He represented that the victims' monies would be used in his profitable businesses.

   d) His businesses have a history of success.
8. It was part of the scheme and artifice to defraud that based upon the fraudulent misrepresentations stated above CECIL RAY DAVIS fraudulently received approximately $2.5 million in principal funds received from victims.
9. It was part of the scheme and artifice to defraud that based upon the fraudulent misrepresentations stated above beginning on or about 2001 until on or about October 2005, CECIL RAY DAVIS solicited and received funds from his victims. Davis promised large rates of return. Davis mailed interest checks to some of the victims in furtherance of the scheme. Davis also occasionally mailed information concerning his businesses to some victims.
10. It was further part of the scheme and artifice to defraud that based upon the fraudulent representations stated above CECIL RAY DAVIS convinced victims to loan thousands of dollars by falsely promising that they would receive twenty to thirty percent (20% -30%) interest per year on their loans.
11. On or about December 31, 2004, in the Western District of Tennessee and elsewhere, the defendant, CECIL RAY DAVIS for the purpose of executing the aforesaid scheme and artifice to defraud and obtain money and attempting to do so, knowingly caused to be placed in an authorized depository for mail matter, to be sent and delivered by the United States Postal Service according to the direction thereon, an envelope which contained a check for $3,000.00,

addressed to Barbara Jones, 2021 Southwind Cove, Dyersburg, TN 38024, and being mailed from Ray Davis, Five D Marketing, P.O. Box 105, Milan, TN 38358, in violation of Title 18, United States Code, Section 1341.

[nmt 5 yrs, nmt $250,000.00 or both, and nmt 3 yrs supervised release, together with a mandatory special assessment of $100.00, see 18 U.S.C. §3013(a).]

COUNT 2

The grand jury alleges all of the allegations contained in Count One, except those contained in paragraph 11.

On or about September 1, 2004, in the Western District of Tennessee, and elsewhere, the defendant, CECIL RAY DAVIS, for the purpose of executing the aforesaid scheme and artifice to defraud and obtain money and attempting to do so, knowingly caused to be placed in an authorized depository for mail matter, to be sent and delivered by the United States Postal Service according to the direction thereon, an envelope which contained a check for $20,000.00 signed by Richard Ayers dated on or about September 1, 2004, addressed to Ray Davis, 6090 East Van Hook Street, Milan, TN 38359, and being mailed from Richard Ayers, 1828 State Route 238, Warsaw, NY 14569, in violation of Title 18, United States Code, Section 1341.

[nmt 5 yrs, nmt $250,000.00 or both, and nmt 3 yrs supervised release, together with a mandatory special assessment of $100.00, see 18 U.S.C. §3013(a).]

Information, Ex. C to Motion for Summary Judgment, Dkt. No. 10. The Debtor pled guilty to both Counts 1 and 2 of the Information. Minute Entry, 01/18/2007, Docket Sheet, Ex. B to Motion for Summary Judgment, Dkt. No. 10. The court may take judicial notice of the facts set forth in the Information as adopted by the Debtor in the Plea Agreement and may take judicial notice of the information in the court's docket sheet. Fed. R. Ev. 201; *see Scholes v. Lehmanm*, 56 F.3d at 762.

The Trustee has alleged facts establishing a Ponzi scheme and transfers to Kelly during the applicable period in furtherance of that scheme. In the Second Circuit, this gives rise to a "Ponzi scheme presumption," which may be a more accurate way to conceive of the effect of the presence of a Ponzi scheme: not that it is conclusive proof of actual intent to defraud, but that it raises a presumption of actual intent to defraud. "If the underlying fraud constitutes a Ponzi scheme, and if the transfer at issue serves to further that scheme, 'actual intent' under the Bankruptcy Code is presumed." *In re Bernard L. Madoff Inv. Securities, LLC,* 2011 WL 3897970, *4 (S.D.N.Y. 2011); *Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 11 (S.D.N.Y. 2007). This presumption may be overcome if the defendant is able to establish facts tending to show, for example, that the transfers to him were not made in furtherance of the Ponzi scheme. *Manhattan Inv. Fund Ltd.*, 397 B.R. at 13.

Thus the court next considers whether the Defendant has introduced evidence concerning the Debtor's intent with respect to the transfers to him that raises a genuine issue for trial. The Defendant's initial response to the Trustee's motion for summary judgment raises no issue with respect to the Debtor's intent. Dkt. No. 14. It is focused instead on whether the Defendant may enjoy the protection of section 548(c). The Defendant's own motion to dismiss, or motion for summary judgment, also raises no issue concerning the Debtor's intent. Dkt. No. 15. It is focused on limiting the Trustee's recovery to transfers made within one year before the filing of the involuntary petition. It is only in Defendant's post-hearing memorandum of law that the Defendant addresses the issue of intent in response to specific questions of the court following oral argument. Dkt. No. 45. There the Defendant points to evidence already in the record that indicates that the Debtor had legitimate business interests going back as far as 1991. *See* Post-Hearing Memorandum, p. 6, fn. 13. The Defendant points to the Trustee's response to Defendant's statements of undisputed facts in which the Trustee admits that Kelly took steps to verify that the Debtor had a business office in Milan, Tennessee, and an import/export business in the Philippines. Dkt. No. 20. The Trustee also admits that Kelly did business with the Debtor in a vending machine business and that Kelly invested in an import/export business. Dkt. No. 20, ¶¶ 4, 5, 6, 7, 14, 15. The Trustee asserts that each of these facts is nonetheless consistent with the Debtor's fraud and that Kelly's "investments" furthered the Debtor's fraudulent scheme. Kelly points to no proof tending to show that the Debtor was not engaged in a fraudulent scheme or, failing that, that his transactions with the Debtor were somehow insulated from the Debtor's fraudulent scheme. The Defendant has raised no genuine issue for trial on the issue of the Debtor's actual intent to hinder, delay or defraud creditors.

The Trustee has satisfied the third element required to establish a fraudulent transfer under the Bankruptcy Code, actual intent to hinder, delay or defraud. He has also established that the Debtor's intent was to defraud creditors. The Information, which the Debtor adopted, recites that the Debtor's scheme began on or about 2001, well before the transfers that fall within the one-year reach-back period under section 548(a)(1)(A), and that payments to "early lenders" were made in perpetration of the fraud: "CECIL RAY DAVIS used these payments to early lenders to attract later lenders and to conceal the scheme to defraud." The Information also recites that the Debtor made payments to early lenders from monies obtained from later lenders to create the illusion of a profit-making business opportunity. The Trustee has adequately described how payments such as those made to Kelly were used to further the Debtor's fraudulent scheme and how those payments harmed creditors of the Debtor, so-called "late lenders." The payments that the Defendant received resulted from taking the funds of later lenders and added an air of legitimacy to the Debtor's scheme that lured other investors or lenders into his trap.

4.

The Trustee has established a prima facie case of actual fraud, or fraud in fact, under section 548(a)(1)(A), with respect to the $8,125 that Kelly received within one year prior to the filing of the involuntary petition. Once he has done this, the burden shifts to the Defendant, Kelly, to prove that he took the transfers for value and in good faith.

In order to establish that he took the transfers for value, Kelly asserts that the payments received by him were in payment of an antecedent debt. Defendant's Memorandum in Support of His Response to Plaintiff's...Motion for Summary Judgment, Dkt. No. 14, p. 2. In fact, the record reflects that Kelly made various loans to the Debtor, and that at the end of the day, Kelly was owed $268,000. Dep. of Kelly, pp. 26-28. This is also the amount that the Debtor admitted that he owed Kelly in connection with his Sentencing Report. Position of Defendant Cecil Ray Davis on Sentencing, Ex. 4 to Notice of Filing, Dkt. No. 41. As one of the petitioning creditors who signed the involuntary petition against the Debtor, Kelly claimed that he was owed $250,000 plus interest and other unknown amounts. Dkt. No. 1, Involuntary Petition, p. 2. In the Defendant's brief in support of his motion for summary judgment, Kelly maintains that, "He invested $268,000.00 and was returned $54,125.00, which was interest only." Dkt. 16, p. 3. While it is true that the Defendant has not filed a proof of claim against the bankruptcy estate, his claim is among those that make up the restitution amount of $10,438,840.27. Dkt. No. 10, Exh. B. The Department of Justice filed a proof of claim in the amount of $10,398,340.27, which is described as "Criminal Restitution Debt." Claims Register, No. 97-1. The attachment to the claim is incomplete, but it is reasonable to infer that the debt acknowledged by the Debtor to be owed to Kelly is among those reflected in this proof of claim. Thus Kelly stands to recover a pro rata share of the bankruptcy estate based on a claim of $268,000.

These facts are at variance with the Defendant's claim that the payments received by him were on account of an antecedent debt. They did not represent a repayment of Kelly's funds but, as he describes it, "interest" on the loans he made to the Debtor, interest that only could have come from funds loaned to the Debtor by "late lenders." Kelly has not shown that credit has been given toward the principal amount for payments he received from the Debtor. Instead, Kelly has maintained that the payments he received were interest only and that he is still owed the entire amount of the funds he loaned to or invested with the Debtor. These facts thus are at variance with the more typical claims of Ponzi scheme investors, permitting the court to distinguish between "net winners" and "net losers." *See Walls v. Cocchini (In re Bolze)*, 2011 WL 2747377 (Bankr. E.D. Tenn. July 13, 2011) (An enlightening discussion of "Ponzi scheme jurisprudence" occurs at *6.). The Defendant has failed to establish that he took $8,125 in transfers from the Debtor for value. The Defendant's section 548(c) defense fails.

5.

Although not necessary to the court's decision because a transferee must prove that transfers were taken both for value *and* in good faith, the court will also consider whether the Defendant took the transfers in good faith. The parties disagree on the standard to be applied to determine "good faith" for purposes of section 548(c). The Trustee urges the court to use an objective standard, while the Defendant urges a subjective standard.

In an earlier opinion delivered in the case of *Teleservices Group,* Bankruptcy Judge Hughes applied a subjective standard to the question of good faith while at the same time acknowledging the clear trend toward use of an objective standard. *In re Teleservices Group, Inc.*, 444 B.R. 767, 795 (Bankr. W.D. Mich. 2011); *see* cases collected at footnote 108. The Ninth Circuit has adopted an objective standard, saying that when employing an objective standard, the court is called upon to determine whether "the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose and a *diligent* inquiry would have discovered the fraudulent purpose." *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Group, Inc.)*, 916 F.2d 528, 536 (9th

Cir. 1990) (emphasis in original). This is the seminal case. Two other courts of appeals have adopted an objective standard for good faith under section 548(c). The Eighth Circuit states that "a transferee does not act in good faith when he has sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency." *Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995). The Tenth Circuit states that "good faith under § 548(c) should be measured objectively and that 'if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent.'" *Jobin v. McKay (In re M & L Business Mach. Co., Inc.),* 84 F.3d 1330, 1338 (10th Cir. 1996), quoting *Agric. Research & Technology Group,* 916 F.2d 528, 536 (9th Cir. 1990). Bankruptcy Judge G. Harvey Boswell of this district also decided that "[g]ood faith is to be measured objectively, rather than subjectively." *Stevenson v. J.C. Bradford & Co.(In re Cannon*), 230 B.R. 546, 592 (Bankr. W.D. Tenn. 1999), *rev'd on other grounds*, 2000 WL 34400479 (W.D. Tenn. March 31, 2000). "Consequently, a transferee may not put on 'blinders' prior to entering into transactions with the debtor and claim the benefit of § 548(c), where circumstances would place the transferee on inquiry notice of the debtor's fraudulent purpose or insolvency." *Id.*

In *Teleservices Group*, Bankruptcy Judge Hughes takes special note of the bankruptcy court's decision in *Bayou Group I,* where the court observed that traditional notions of good faith and bad faith, both of which involve a moral judgment, have no application to section 548(c), because it "is not a punitive provision designed to punish the transferee, but is instead an equitable provision that places the transferee in the same position as other similarly situated creditors who did not receive fraudulent conveyances." *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group),* 396 B.R. 810, 827 (Bankr. S.D.N.Y. 2008), rev'd in part, 439 B.R. 284

(S.D.N.Y. 2010). Bankruptcy Judge Hughes suggests that this distinction is the province of preferential and constructively fraudulent transfers, but not actually fraudulent transfers. With respect to actually fraudulent transfers, the only question with respect to the transferee is whether he had knowledge of and thus was complicit in the fraud. If he was not, then he is protected. If he had knowledge and was complicit, then he is not entitled to the fruits of the fraud. *Teleservices Group*, 444 B.R. at 808. But Bankruptcy Judge Hughes simultaneously recognizes that it is what the transferee does or does not do as one or more of the traditional badges of fraud comes to his attention that provides evidence of good faith or the lack of it. This, he says, is not an objective test, but rather an evidentiary standard. Just as a transferor seldom admits his fraudulent intent in making a transfer, and the trier of fact must rely upon circumstantial evidence, i.e., the traditional badges of fraud, so too it is the rare transferee who will admit his knowledge of the fraud. The difference, he suggests, is analogous to the difference between justifiable and reasonable reliance. *Id.* at 815-16, citing *Field v. Mans,* 516 U.S. 59, 116 S. Ct. 437 (1995) (applying the standard of justifiable reliance when actual fraud is at issue). Bankruptcy Judge Hughes explains that the test he will apply will be a subjective one, focused on the particulars at hand, in which the transferee's conduct is compared to standards such as "integrity, trust, and good conduct." *Id.*, quoting, *Bayou Group I*, 396 B.R. at 847. Again calling on *Field v. Mans,* Bankruptcy Judge Hughes indicates that objective factors will have a place:

> Our reading of the Act does not leave reasonableness irrelevant, for the greater the distance between the reliance [read, "good faith"] claimed and the limits of the reasonable, the greater the doubt about reliance [good faith] in fact. Naifs may recover, at common law and in bankruptcy, but lots of creditors are not at all naive. The subjectiveness of justifiability [good faith] cuts both ways, and reasonableness goes to the probability of actual reliance [good faith].

Field v. Mans, 516 U.S. at 76, 116 S. Ct at 446, quoted at *Teleservices,* 444 B.R. 816, n.164. *Teleservices Group* seems to imply that in cases of actual fraud, a hybrid test should be applied to determine whether the transferee took the transfers in good faith. This court agrees that this hybrid test, which looks at the subjective intent of the transferee in light of objective factors, such as his knowledge of the presence of "badges of fraud" or "red flags" that should have put him on inquiry notice, comports well with the history and purpose of laws protecting creditors from fraudulent transfers. The Fifth Circuit Court of Appeals approved the use of what appears to be a hybrid test to the determination of good faith in connection with a Ponzi scheme in *Jimmy Swaggart Ministries v. Hayes (In re Hannover Corp.),* 310 F.3d 796 (5th Cir. 2002). In that case, the bankruptcy judge did a painstaking review of the transferee's state of mind, whether its knowledge of the fraud was actual or merely constructive, and the duty imposed upon it by notice. Most telling, said the court of appeals, was the bankruptcy judge's finding that at the time of the transfers, the transferee had no way of knowing that the debtors were insolvent. It was put on inquiry notice that the transferor was the subject of an SEC investigation, but made its own investigation that included contacting the SEC and the federal district court. Having received reassurances from those sources, the transferee continued to receive payments from the transferor, payments which the bankruptcy judge found to be protected by the good faith defense. The court of appeals affirmed, noting that "there is little agreement among courts regarding the appropriate legal standard for this defense, because '[t]he unpredictable circumstances in which the courts may find its presence or absence render any definition of "good faith" inadequate, if not unwise.'" *Id.* at 800, quoting 5 Collier on Bankruptcy, ¶ 548.07[2][a].

Under the authorities that have been reviewed, a consensus seems to emerge that the court must conduct a three-step inquiry to determine a transferee's good faith for purposes of section 548(c). First, the court must determine what the transferee actually knew *that would suggest insolvency or a fraudulent purpose* with respect to the transferor. This is the sort of information that triggers inquiry notice. *In re Bayou Group, LLC,* 439 B.R. 284, 314-15 (S.D.N.Y. 2010). In the second step of the test, the court must determine whether the transferee undertook a *diligent* inquiry and the results of that inquiry. In the third step of the test, if *diligent* inquiry did not discover the fraud, the court must determine whether any reasonable investigation would have disclosed the transferor's insolvency or fraudulent intent. *Id.* at 315. The good faith standard is not a negligence standard. That is, the failure of the transferee to undertake a reasonable investigation or any investigation before making an investment is not at issue. *See Teleservices Group,* 444 B.R. at 815. It is only when the transferee becomes aware of facts that call into question the transferor's solvency and/or intent that the duty of inquiry arises.

The first step in the evaluation of the good faith of a transferee is an investigation into what the transferee in fact knew. That is, was the transferee subjectively aware of "badges of fraud" or "red flags" that raised a duty of inquiry? Although we will turn first to the allegations of the Trustee, the burden of proof remains on the Defendant to demonstrate his good faith, not on the Trustee to demonstrate a lack of good faith. The facts that the Trustee points to as "red flags" known by Kelly are these:

> 8. [Kelly] "invested" with Davis because friends told him Davis was paying them a return of twenty-five to thirty percent on their investments with him. Kelly Dep., pp. 9-11.
>
> 10. Other investments Kelly had were earning eleven percent, twelve percent, and seventeen percent. Kelly Dep., p. 14.

12. Davis paid Kelly with post-dated checks. Kelly Dep., p. 25.

14. According to Kelly, Davis' proposed interest rate returns were "so magnificent that you did not negotiate them." Kelly Dep., p. 36, line 17.

15. Kelly would "lend" money to Davis. Davis repaid those loans at a rate of twenty-five or thirty percent. Kelly Dep., p. 34.

16. On one occasion, Kelly lent Davis $30,000.00 for six weeks. It earned $3,000 of interest, or a rate of 80% or 90% interest per annum. Kelly Dep., pp. 35-36.

17. Kelly admits that 80% or 90% interest is "pretty high." Kelly Dep., pp. 35-36.

18. Kelly knew that the checks he was receiving from Davis came from multiple accounts, some "corporate," some "individual." Kelly Dep., p. 75.

Statement of Undisputed Facts Submitted in Support of Trustee's Motion for Summary Judgment, Dkt. No. 10. The majority of the facts relied upon by the Trustee relate to the rate of return promised by the Debtor and received by the Defendant. The Defendant explains that he first became interested in Davis when friends told him about the rates of return they were receiving from a vending machine business they were in with Davis. This occurred in 1999. It was in that context that Kelly learned of rates of return at 25-30%. Kelly Dep., pp. 8-9. The first investment that Kelly made with Davis involved the purchase of 100 vending machines in 1999 or 2000. *Id.* at 9. The Trustee relies upon proof indicating that the Ponzi scheme began on or about 2001. Information, § 1. Any transfers made to Kelly prior to that time could not have been made in furtherance of the scheme, and the Trustee makes no claim concerning such transfers if there were any.

Kelly indicates that in his discussions with his friends before investing, he was told that they were being paid as promised – on time and at the rate promised. Kelly Dep., pp. 9, 19. Kelly testified that he became aware of Davis' financial problems in the way of lawsuits, collections, or demands some time in 2004. Kelly states: "It was always some excuse that gasoline went up or the people were charging more money to collect the money or the quarters out of the machines and he couldn't find anybody to work. The pay just started dwindling. . . . [I]t started coming in late and then it stopped." Kelly Dep., p. 20. Kelly stated that this occurred in late 2004. He received three checks in February 2005 and then nothing more until August 2005, when he received two bad checks. Kelly Dep., pp. 20, 82-84. It was "toward the end of the situation" that Kelly asked Davis "whether or not this was a Ponzi scheme and he denied it." Kelly Dep., pp. 82-83.

The three transfers that Kelly received during the reach-back period under section 548(a)(1) (all dated in March 2005) occurred *after* Kelly admits that he became aware of Davis's financial problems. Defendant's Response to Request for Admissions, Ex. D. to Trustee's Motion for Summary Judgment, Dkt. No. 10. When Kelly became aware of Davis's financial problems, he was put on inquiry notice, and had a duty to undertake a *diligent* inquiry concerning Davis's financial situation. The only inquiry that appears in the record was his question to Davis about a Ponzi scheme. Kelly admits that at this time he was having trouble getting paid by Davis, Davis was making a series of excuses for nonpayment, and Kelly was aware that other people were also not getting paid. Kelly Dep., pp. 83-84. As a result, the final three transfers received by Kelly are not protected by the good faith defense of section 548(c). The Defendant's section 548(c) defense fails for the additional reason that he did not take these transfers in good faith.

6.

The Trustee is entitled to summary judgment with respect to his claims arising under section 548(a)(1) of the Bankruptcy Code. The three transfers that the Defendant received in March 2005 in the aggregate amount of $8,125 represent transfers of an interest of the Debtor in property made on or within one year prior to the filing of the involuntary bankruptcy petition with actual intent to defraud creditors. The transferee, Kelly, has failed to demonstrate that he took the transfers for value or in good faith. The transfers may be avoided. Moreover, Kelly, as the initial transferee, is obligated to repay the bankruptcy estate for the full amount of these transfers. 11 U.S.C. § 550(a)(1).

D.

The court next turns to consideration of the Trustee's claim to recover the remaining transfers from the Debtor to the Defendant during the period May 30, 2003, to December 17, 2004, in the aggregate amount of $46,000. The Trustee seeks to recover these transfers pursuant to section 544(b)(1) of the Bankruptcy Code, which permits a trustee to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title." 11 U.S.C. § 544(b)(1). With respect to applicable law, the Trustee points to Tennessee Code Annotated §§ 66-3-101 et seq, 66-3-305, 66-3-306. Complaint, Dkt. No. 1.

The Trustee's original motion for summary judgment included no reference to section 544(b)(1) of the Bankruptcy Code. It was only at oral argument, and pursuant to a reminder by the court, that counsel for the Trustee remembered to include an argument concerning section 544. His counsel made that request in writing in both their post-hearing letter brief and Amended Motion for Summary Judgment and Supporting Memorandum of Law. Dkt. Nos. 46 and 47. Unfortunately, the Trustee's position on these claims is very scantily briefed. The Trustee has made passing reference to numerous sections of the Tennessee Code, which contain alternative theories of relief.

There is no specific discussion concerning which statutes and legal theories the Trustee relies upon and how the facts established by the record relate to those legal theories. Although the court has some idea of the arguments that might be made by the Trustee under Tennessee law, the court refuses to enter upon that endeavor for him. Most importantly, the court will not assume that the interpretations of fraudulent transfer law under the Bankruptcy Code are the same as those under Tennessee law. Likewise, although the Defendant has asked for summary judgment as to both counts of the complaint, he has not addressed the Trustee's claim under section 544 of the Bankruptcy Code.

Accordingly, both motions for summary judgment will be denied with respect to the Trustee's claims under section 544(b)(1) of the Bankruptcy Code, without prejudice to the refiling of the motions as to those claims with appropriate briefing.

V.

For the reasons set forth above, I make the following recommendations concerning the motions pending in this adversary proceeding:

1. As to Count I of the complaint, the motion of the Trustee for summary judgment be **GRANTED IN PART** and **DENIED IN PART**. Summary judgment should be **GRANTED** for the Trustee against the Defendant Kelly in the amount of $8,125 as to the Trustee's claim pursuant to 11 U.S.C. § 548(a)(1). The Trustee's motion concerning his claim under 11 U.S.C. § 544(b)(1) should be **DENIED** without prejudice to its being renewed with appropriate briefing.
2. The motion of the Defendant to dismiss and for summary judgment as to the Count I of the complaint should be **DENIED.** The Trustee's claim under 11 U.S.C.

§ 544(b)(1) should be **DENIED WITHOUT PREJUDICE** to its being renewed with proper briefing.

3. As to Count II of the complaint, the motion of the Trustee should be **DENIED** and the motion of the Defendant be **GRANTED**. Count II of the complaint should be **DISMISSED WITH PREJUDICE.**

cc: Trustee
Trustee's Attorney
Defendant
Defendant's Attorneys
Clerk of the District Court
Debtor
Debtor's Attorney