Dated: August 15, 2012
The following is ORDERED:

Jennie D. Latta
UNITED STATES BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE

In re

CECIL RAY DAVIS,

Debtor.

Case No. 05-15794- GWE
Chapter 7

MICHAEL TABOR,
Chapter 7 Trustee,
Plaintiff,
v.
CHARLES KELLY, SR.,
Defendant.

Adv. Proc. No. 07-05181-L

RECOMMENDATION CONCERNING
REQUESTS FOR CERTIFICATION

BEFORE THE BANKRUPTCY COURT is the Request for Certification of Questions to the Tennessee Supreme Court filed by the Defendant, Charles Kelly, Sr. (The "Defendant" or "Kelly"). Pursuant to Rule 23 of the Rules of the Tennessee Supreme Court, the Defendant asks that the following questions be certified to the Tennessee Supreme Court:

1. To avoid transfers as fraudulent under Tennessee law, T.C.A. § 66-3-405, may a bankruptcy trustee (or other plaintiff) establish fraudulent intent by simply showing that the transferee was promised or received high rates of return without some other showing of fraud?

2. Must the bankruptcy trustee (or other plaintiff) seeking to avoid as fraudulent transfers purportedly made in connection with a Ponzi scheme demonstrate that each specific transfer is fraudulent pursuant to T.C.A. § 66-3-305? More specifically, if the plaintiff in a fraudulent transfer action is able to establish the existence of a Ponzi scheme, in order to avoid specific transfers, must the plaintiff also show that each transfer specifically furthered the scheme in some way?

3. For purposes of Tennessee fraudulent transfer law, T.C.A. § 66-3-304 and 66-3-309, does an innocent investor in a Ponzi scheme receive reasonably equivalent value up [to] the amount of his or her initial investment?

4. For purposes of Tennessee fraudulent transfer law, including specifically, for purposes of T.C.A. § 66-3-309, is good faith still determined from the transferee's viewpoint, as it was under prior law?

5. Is a guilty plea by a defendant who is not a party to [a] subsequent civil action admissible in that civil action?

6. May the court in a subsequent civil action take judicial notice of statements in a guilty plea when the parties to the civil action were not parties to the criminal proceeding and the criminal defendant is not a party to the civil action?

7. Are transfers that pre-date the adoption of the Tennessee Uniform Fraudulent Transfer Act, T.C.A. § 66-3-301 et seq., protected from avoidance after three years from the date of transfer?

Doc. No. 95. In support of his request for certification, the Defendant relies upon a number of documents in the record, Nos. 85-92, 94, and 10.

The Trustee filed a response in which he urges the court not to certify questions to the Tennessee Supreme Court because of the significant delay that would presumably introduce into the resolution of this adversary proceeding, but nevertheless suggests that if the court decides to certify questions, the list of questions be expanded to include the following:

1. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is the fraud or fraudulent intent the plaintiff must prove the fraud of the transferor?

2. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is proof of a criminal conviction admissible as an exception to the hearsay rule as evidence of fraud?

3. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is proof of a Ponzi scheme proof of the transferor's actual fraud?

4. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., does proof of any of the badges of fraud establish lack of good faith on the part of the transferor?

5. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is the transferee's lack of good faith evaluated using an objective standard?

6. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., when a fraudulent scheme falsely labels transfers as "investment returns," is there any basis for creating the fiction that the fraudulent scheme was a legitimate business enterprise?

Doc. No. 97. In support of his request, the Trustee relies upon a number of documents: Doc. Nos. 10 (and exhibits), 19, 46, 48, and 67 (and exhibit).

The Defendant responds to the Trustee's proposed questions for certification as follows:

i. The Trustee fails to include any question concerning reasonably equivalent value, which is critical to the outcome of the remaining adversary proceedings, because, to the best of Kelly's knowledge, the defendants in the remaining adversary proceedings (including Kelly) all received back from the Debtor less than their original investments;

ii. The Trustee's proposed question regarding the admissibility of the guilty plea fails to specify that the plea is offered in a subsequent civil proceeding in which none of the parties were parties to the criminal proceeding;

iii. The Trustee's proposed question regarding the badges of fraud generally apparently presumes that a promised or paid interest rate of a certain amount is a badge of fraud; and

iv. The Trustee fails to include any question regarding the treatment of payments predating the adoption of the Uniform Fraudulent Transfer Act.

Further, the Trustee seeks certification of questions relating to fraudulent transfers under the Fraudulent Conveyances and Devises Act (in addition to the Uniform Fraudulent Transfer Act), which by its plain language applies only to "conveyances" and "devises" of "land, tenements, hereditaments, goods or chattels." T.C.A. § 66-3-101, -201. The payments to Kelly (and presumably other defendants as well) were transfers of money, not conveyances or devises of land, tenements, hereditaments, goods or chattels. The Trustee has proceeded under the Uniform Fraudulent Transfer Act, and should not be allowed to now broaden his claims.

Doc. No. 98.

ANALYSIS

Tennessee Supreme Court Rule 23 provides for the certification of questions to the Tennessee Supreme Court "when the certifying court determines that, in the proceeding before it, there are questions of law of this state which will be determinative of the cause of action and as to which it appears to the certifying court there is no controlling precedent in the decisions of the Supreme Court of Tennessee. Even though a federal district court or bankruptcy court may certify a question, the Tennessee Supreme Court retains the discretion to accept (or reject) the question for determination.

In the first instance, a federal court must determine whether the prerequisites for certification are present. In this case, that means that I must consider each of the proposed questions in turn.

Defendant's Question 1. To avoid transfers as fraudulent under Tennessee law, T.C.A. § 66-3-405, may a bankruptcy trustee (or other plaintiff) establish fraudulent intent by simply showing that the transferee was promised or received high rates of return without some other showing of fraud?

This question of the Defendant is an evidentiary question. It asks whether proof of the promise or receipt of high rates of return is sufficient to establish fraud for purposes of Tennessee Code Annotated section 66-3-405. There is no such section. I assume that the Defendant intends

Tennessee Code Annotated section 66-3-305. That section includes two causes of action, one based upon the "actual intent to hinder, delay, or defraud any creditor of the debtor." Tenn. Code Ann. § 66-3-305(a)(1). The second is concerned with transactions in which the transferor received less than "a reasonably equivalent value in exchange for the transfer or obligation." Tenn. Code Ann. § 66-3-305(a)(2). Subsection (b) contains a list of the traditional badges of fraud that a court may consider in determining "actual intent" under subsection (a)(1). None of those specifically mentions the promise or receipt of high rates of return," but does mention as one indication of fraud that "the value of the consideration received by the debtor was [not] reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred." Tenn. Code Ann. § 66-3-305(b)(8). The assets transferred by the Debtor, Davis, in this case, was money or its equivalent. The Defendant asserts that these funds were transferred to him by the Debtor as interest paid on account of an investment in the Debtor's import/export business. *Defendant's Brief in Support of Motion for Summary Judgment*, Doc. No. 16, p. 3. Section 66-3-305 is accompanied by extensive official comments.[1] Comment (5) notes that:

> Subsection (b) is a nonexclusive catalogue of factors appropriate for consideration by the court in determining whether the debtor had an actual intent to hinder, delay, or defraud one or more creditors. Proof of the existence of any one or more of the factors enumerated in subsection (b) may be relevant evidence as to the debtor's actual intent but does not create a presumption that the debtor made a fraudulent transfer or incurred a fraudulent obligation.

[1] Tenn. Code Ann. § 66-3-313 provides that the official comments shall constitute evidence of the purposes and policies underlying sections, unless the section at issue differ materially from the official text that would be applicable or the official comments are inconsistent with the plain meaning of the applicable section.

Comment (6) notes that, "In considering the factors listed in § 4(b) [§ 66-3-305(b)] a court should evaluate all the relevant circumstances involving a challenged transfer or obligation. Thus the court may appropriately take in to account all indicia negativing as well as those suggesting fraud ..."

The payment of excessive rates returns is one indication of fraud. It is not sufficient to demonstrate fraud, but the Trustee has nowhere claimed that it is. There is no need to certify this question to the Tennessee Supreme Court as the answer is clearly given in the statute itself and the comments to it.

> **Defendant's Question 2. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is proof of a criminal conviction admissible as an exception to the hearsay rule as evidence of fraud?**

This is a question of evidence, not of weight. The question asks whether proof of a criminal conviction is admissible as an exception to the hearsay rule. Tennessee Rule of Evidence 804(b)(3) is identical to Federal Rule of Evidence 804(b)(3). It provides:

> (3) *Statement Against Interest.* A statement which was at the time of its making so far contrary to the declarant's pecuniary or proprietary interest, or so far tended to subject the declarant to civil or criminal liability or to render invalid a claim by the declarant against another, that a reasonable person in the declarant's position would not have made the statement unless believing it to be true.

The hearsay exceptions found at Rule 804 are applicable only when a declarant is unavailable. A declarant is unavailable when he "is absent from the hearing and the proponent of a statement has been unable to procure the declarant's attendance by process." Tenn. R. Evid. 804(a)(5). It is inappropriate at this stage to determine whether the Debtor's testimony can be procured, but assuming that it cannot, proof of his criminal conviction generally will be admitted as a statement against interest. In *Grange Mut. Cas. Co. v. Walker*, 652 S.W.2d 908, 910 (Tenn. Ct. App. 1983), the court of appeals noted that, "[a] plea of guilty ... is generally not conclusive on the issues in a

subsequent civil action, but is competent evidence as an admission against interest." *Id.* (citations omitted). *See also Akers v. Prime Succession of Tennessee, Inc.*, 2011 WL 4908396, *18 (Tenn. Ct. App. 2011) (plea of guilty constitutes competent evidence as an admission against interest, and makes it more likely than not that facts are as stated); *McCain v. Vaughn*, 1999 WL 95974, *4 (Tenn. Ct. App. Feb. 26, 1999) (guilty plea was admissible, but did not work an estoppel). These decisions concerning Tennessee law are consistent with the leading treatise on issues of evidence in bankruptcy, Barry Russell, *Bankruptcy Evidence Manual*, 2011-2012 Edition (Thomson Reuters, 2011), which states: "a plea of guilty may be admissible as an admission of a party under Rule 801(d)(2)(A) or as a statement against interest of a non-party under Rule 804(b)(3)." Bankr. Evid. Man. § 801:14. This rule does not seem to be in serious dispute and need not be submitted to the Tennessee Supreme Court for decision.

> **Defendant's Question 3. For purposes of Tennessee fraudulent transfer law, T.C.A. § 66-3-304 and 66-3-309, does an innocent investor in a Ponzi scheme receive reasonably equivalent value up [to] the amount of his or her initial investment?**
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> Tennessee Code Annotated § 66-3-304 provides:
>
> (a) Value is given for a transfer or an obligation if, in exchange for the transfer or obligation, property is transferred or an antecedent debt is secured or satisfied, but value does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person.
>
> (b) For the purposes of §§ 66-3-305(a)(2) and 66-3-306, a person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust, or security agreement.
>
> (c) A transfer is made for present value if the exchange between the debtor and the transferee is intended by them to be contemporaneous and is in fact substantially contemporaneous.

Section 66-3-309 provides an exception to section 66-3-305(a)(1) for a person who took in good faith and for a reasonably equivalent value.

Section 66-3-304 by its terms applies to sections 66-3-305(a)(2) and 66-3-306. Both of these sections permit recovery for transfers that are "constructively" fraudulent. That is, regardless of the intent of the transferor, certain transfers may be avoided under the circumstances described in those sections. Section 66-3-309 applies by its terms to section 66-3-305(a)(1), which is a section that permits avoidance of transfers made by a transferor with "actual intent to hinder, delay, or defraud any creditor of the debtor."

Section 66-3-304 defines value in terms of property transferred or an antecedent debt secured or satisfied. The question asks whether an innocent investor in a Ponzi scheme receives reasonably equivalent value up [to] the amount of his or her initial investment. By "innocent investor" I assume that the question assumes that the investor had no knowledge of the Ponzi scheme. The question asks whether an investor receives reasonably equivalent value in certain contexts. This is not the question that is asked under sections 66-3-305(a)(2) and 66-3-306. The question these sections pose is whether the **transferor** – in this case, the Debtor – received reasonably equivalent value – for his transfers.[2] Thus, with these amendments, the question asks:

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[2] Section 66-3-305(a)(2) provides: "A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation incurred, **if the debtor made the transfer or incurred the obligation ... [w]ithout receiving a reasonably equivalent value** in exchange for the transfer or obligation ...."

Section 66-3-306(a) provides: "A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred **if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value** in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation." (emphasis added).

> Whether a debtor who makes a transfer to an investor who has no knowledge of a Ponzi scheme receives reasonably equivalent value for the transfer if the amount of the transfer does not exceed the amount of the investment?

I believe that the answer should be "it depends." It depends upon how the parties account for the transfer. If they treat it as a return of the original investment or loan, then a reasonably equivalent value is given because, in the words of the statute, "an antecedent debt is satisfied." If, on the other hand, the transfer is treated as "interest," then the antecedent debt is not satisfied but remains outstanding. If, pursuant to the parties' agreement, interest has accrued and is owing, then that debt (the debt for interest) may be satisfied when interest is paid, but I see no reason to treat a transfer as a return of principal unless the parties treat it as such. The fraudulent transfer laws are intended to prevent depletion of the debtor's estate to the detriment of creditors.[3] If, after a transfer, the estate is not replenished either by an increase in assets or by the satisfaction of an outstanding liability, then the estate has been diminished.

In my prior recommendation I noted that Kelly had taken the position that he was owed $268,000, that he had received checks from the Debtor in the aggregate amount of $54,125, and that this was "all interest," indicating that the believed that he was still owed $268,000. Since then Kelly has provided a declaration in which he states that he made loans to the Debtor in the amount of $250,000 (or $220,000), and received back $54,125, resulting in "a net loss of more than $195,000" (actually $195,875). Declaration of Charles Kelly, May 21, 2012, Doc. No. 87. Kelly has not filed a proof of claim, so it is difficult for me to determine how much he claims that he is still owed. He

[3] *See* Tenn. Code Ann. § 66-3-304, Comments to Official Text (2): "Section 3(a) [T.C.A. § 66-3-304] is adapted from § 548(d)(2)(A) of the Bankruptcy Code.... 'Value' is to be determined in light of the purpose of the Act to protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors. Consideration having no utility from a creditor's viewpoint does not satisfy the statutory definition."

seems to have changed his position as the result of my prior recommendation concerning the first motions for summary judgment. If his position now is that he is owed $195,875, then he needs to make the United States Attorney aware of this fact so that the Debtor's restitution order can be adjusted. In any event, these are factual issues that do not bear upon the question posed for possible certification to the Tennessee Supreme Court. In my opinion, the question posed is straightforward and capable of easy determination based upon the statute itself.

> **Defendant's Question 4. For purposes of Tennessee fraudulent transfer law, including specifically, for purposes of T.C.A. § 66-3-309, is good faith still determined from the transferee's viewpoint, as it was under prior law?**

As stated above, section 66-3-309(a) applies to section 66-3-305(a), which is an "actual fraud" statute. Section 66-3-309(a) by its terms refers to "a person who took in good faith." Good faith is determined from the transferee's point of view. There is no need to certify this question to the Tennessee Supreme Court.

> **Defendant's Question 5. Is a guilty plea by a defendant who is not a party to [a] subsequent civil action admissible in that civil action?**

This question was already answered in response to Question 2. A prior guilty plea is admissible as an admission against interest under Rule 804(b)(3).

> **Defendant's Question 6. May the court in a subsequent civil action take judicial notice of statements in a guilty plea when the parties to the civil action were not parties to the criminal proceeding and the criminal defendant is not a party to the civil action?**

This question is also answered by Rule 804(b)(3). A prior guilty plea is a statement against interest and may be admitted under Rule 804(b)(3) when the declarant is not available. According to Bankruptcy Judge Russell, "The assumption that people do not make false statements damaging to themselves furnishes the basis for this exception." *Bankruptcy Evidence Manual*, § 804:6. The

weight to be given to these statements is a matter for the trier of fact. The Tennessee Supreme Court agrees:

> A statement against penal interest is deemed sufficiently reliable to constitute an exception to the hearsay rule because
>
> > a reasonable person similarly situated to the declarant would not have made the statement unless the reasonable person believed it was true. In turn, this statement means that a reasonable declarant would have realized it was against his or her interest. The important time is when the statement was made.
> >
> > Rule 804(b)(3) does not specifically provide that the declarant must have personally known that the statement was against his or her interests when it was made. However, this knowledge is the reason the hearsay statement is viewed as sufficiently reliable to be admitted, and *the evidence should not be admitted if it is established that the declarant did not know that the statement was harmful.*

State v. Kiser, 284 S.W.3d 227, 265 (Tenn. 2009), quoting Neil P. Cohen, et al., *Tennessee Law of Evidence* § 8.63(5) (5th ed. 2005). There is no reason to certify this question to the Tennessee Supreme Court.

> **Defendant's Question 7. Are transfers that pre-date the adoption of the Tennessee Uniform Fraudulent Transfer Act, T.C.A. § 66-3-301 *et seq.*, protected from avoidance after three years from the date of transfer?**

The Tennessee Fraudulent Transfer Act was adopted and became effective July 1, 2003. Two of the transfers that are at issue in this adversary proceeding occurred prior to the effective date of the statute. *See Tabor v. Kelly (In re Davis)*, 2011 WL 5429095, at *16. Although one court has held that the Uniform Fraudulent Transfer Act applies retroactively, most do not. *See* cases collected at 37 Am. Jur. 2d, *Fraudulent Conveyances and Transfers* § 5 (updated 2012). The Tennessee Supreme Court does not appear to have addressed this issue, but there does not appear

to be a serious dispute. The Tennessee Uniform Fraudulent Transfer Act should not be applied retroactively.

This concludes my discussion of the questions raised for possible certification by the Defendant. The Plaintiff urges the court not to certify questions to the Tennessee Supreme Court, but nevertheless suggests a number of questions that he would like answered if questions are certified. The Plaintiff raises the following questions.

> **Plaintiff's Question 1. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is the fraud or fraudulent intent the plaintiff must prove the fraud of the transferor?**

Tennessee Code Section 66-3-101 is derived from Tennessee Acts of 1801, ch. 25, § 2. It was not repealed by the uniform law relating to fraudulent conveyances, but augments it. *See Scarborough v. Pickens*, 26 Tenn. App. 213, 170 S.W.2d 585 (1942). By its terms, the act applies to "[e]very gift, grant, conveyance ... [and to] every bond, suit, judgment, or execution, had or made and contrived of malice, fraud, covin, collusion, or guile, to the intent or purpose to delay, hinder, or defraud creditors ...." The terms covin and collusion contemplate a conspiracy, which would require the participation of more than one person, but the act is broader than covin and collusion. The act *includes* transfers in which the fraud of someone other than the transferor may be proven, but it does not *require* it. The fraud to be proved is that of the transferor. Where there is " no fraud in fact, or apparent upon the face of the instrument, the deed of trust may be held good as a security for [bona fide debts secured by it]." *Neuffer, Hendrix & Co. v. Pardue*, 3 Sneed 91, 1855 WL 2439, *2 (Tenn. 1855). This principle is restated as that of "reasonably equivalent value" set out in the Uniform Fraudulent Transfer Act.

The Uniform Act is clear that it is the debtor-transferor's intent that is in question: "[a] transfer made or obligation incurred **by a debtor** is fraudulent ... if **the debtor** made the transfer or incurred the obligation ... with actual intent to hinder, delay, or defraud any creditor of the debtor." Tenn. Code Ann. § 66-3-305(a)(1)(emphasis added). The exception articulated by the Tennessee Supreme Court in *Neuffer, Hendrix* is codified at section 66-3-309(a): "A transfer or obligation is not avoidable under § 66-3-305(a)(1) against a person who took in good faith and for a reasonably equivalent value ...." It is not necessary for a plaintiff to prove that the transferee participated in the transferor's fraud. Nor is it necessary for the plaintiff to prove lack of good faith or a transfer not for a reasonably equivalent value. These are defenses that must be raised and proved by the defendant. *See* Tenn. Code Ann. § 66-3-308, Comments to Official Text (1): "Subsection (a) states the rule that applies when **the transferee establishes** a complete defense to the action for avoidance based on Section 4(a)(1) [T.C.A. § 66-3-3-5(a)(1)].... The person who invokes the defense carries the burden of establishing good faith and the reasonable equivalence of the consideration exchanged." (emphasis added).

> **Plaintiff's Question 2. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is proof of a criminal conviction admissible as an exception to the hearsay rule as evidence of fraud?**

This question has been answered. Proof of a guilty plea is admissible as a statement against interest if the declarant is not available. Tenn. R. Evid. 804(3).

> **Plaintiff's Question 3. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is proof of a Ponzi scheme proof of the transferor's actual fraud?**

As I stated in my prior recommendation, proof of the existence of a Ponzi scheme gives rise to a presumption that transfers made by the debtor during the existence of the scheme were made

in furtherance of it. *See Tabor v. Kelly,* 2011 WL 5429095 at *21. This presumption may be overcome if the defendant is able to show, for example, that the transfers to him were not made in furtherance of the Ponzi scheme. *Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.*), 397 B.R. 1, 13 (S.D.N.Y. 2007). The Tennessee Supreme Court has not discussed this issue, but it does not appear to be in dispute. Evidence of the existence of a Ponzi scheme is relevant evidence tending to show that transfers were made with fraudulent intent. It is not conclusive proof, but it is certainly relevant proof that would be admissible under Tennessee Rule of Evidence 402.

If the question is intended to ask whether proof of a Ponzi scheme may be used as a form of offensive collateral estoppel, I would say no. The Defendant was not a party to the plea agreement and had no opportunity to question the Debtor concerning the statements contained in the criminal Information. He should be given the opportunity to rebut the inferences that arise as the result of the Debtor's guilty plea.

Plaintiff's Question 4. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., does proof of any of the badges of fraud establish lack of good faith on the part of the transferor?

As explained in response to Plaintiff's Question 1, good faith is an affirmative defense that must be raised and proved by the transferor. The plaintiff must prove an intent to hinder, delay, or defraud creditors. The "badges of fraud" are non-exclusive and non-conclusive ways of proving fraudulent intent. A transferor may act with fraudulent intent, but a transferee may nevertheless be protected if he takes in good faith and for reasonable equivalent value. There is no question here requiring certification to the Tennessee Supreme Court.

Plaintiff's Question 5. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., is the transferee's lack of good faith evaluated using an objective standard?

The Tennessee Supreme Court has not addressed this question, but the interpretation of good faith under the Uniform Fraudulent Transfers Act does not seem to be in serious dispute. The federal courts have almost unanimously concluded that the good faith standard under the Uniform Fraudulent Transfers Act, like its counterpart under the Bankruptcy Code, should be evaluated under an objective standard. *See Osherow v. Nelson Hensley & Consolidated Fund Management, L.L.C. (In re Pace)*, 456 B.R. 253, 275 (W.D. Tex. 2011) (Texas law) ("The relevant inquiry is what the transferee 'objectively knew or should have known instead of examining the transferee's actual knowledge from a subjective standpoint.'"); *Roeder v. Lockwood (In re Lockwood Auto Group, Inc.*), 428 B.R. 629, 636 (Bankr. W.D. Pa. 2010) (Pennsylvania law) ("[G]ood faith is determined according to an objective or 'reasonable person' standard, and not based on the subjective knowledge or belief of the transferee. Courts thus look to what the transferee objectively knew or should have known concerning the nature of the underlying circumstances involved with the transfer."); *Ameriserv Financial Bank v. Commercebank, N.A.*, 2009 WL 890583, (W.D. Pa. 2009) ("The holdings in this Circuit comport with the generally-accepted analysis of a good faith defense under the related provisions of either the Bankruptcy Code or the Uniform Fraudulent Transfers Act ("UFTA"). *See In re Bayou Group*, 396 B.R. at 844-45 (concurring that federal courts have reached a consensus that "good faith" under the Bankruptcy Code provisions is determined according to an "objective" or "reasonable person" standard and not on the subjective knowledge or belief of the transferee, and that under this standard the "courts look to what the transferee objectively 'knew or should have known'"); *id.* (citing extensively to case law, including cases interpreting/analyzing

"analogous" provisions under UFTA)."); *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group, LLC*), 396 B.R. 810, (Bankr. S.D.N.Y. 2008), rev'd in part on other grounds, *In re Bayou Group, LLC*, 439 B.R. 284 (S.D.N.Y. 2010); *In re Manhattan Inv. Fund*, 2007 WL 4440360, at *17; *Enron Corp. v. Avenue Special Situations Fund II, L.P. (In re Enron Corp.)*, 340 B.R. 180, 207 (Bankr. S.D.N.Y. 2006), rev'd on other grounds, 379 B.R. 425, 2007 WL 2446498 (S.D.N.Y. Aug.27, 2007); *see also Warfield v. Byron*, 436 F.3d 551, 559-60 (5th Cir.2006) (analyzing analogous provision under Uniform Fraudulent Transfer Act); *Jobin v. McKay*, 84 F.3d at 1337-38 (10th Cir. 1996); *Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995); *In re Agric. Research and Tech. Group, Inc.*, 916 F.2d at 535-36 (recognizing that UFTA provision is interpreted same as § 548(c)); *Terry v. June*, 432 F. Supp. 2d 635, 641 (W.D. Va. 2006) (analyzing analogous provision under UFTA").

The one state court decision that I was able to locate agrees with the federal court majority. *See Herup v. First Boston Financial, LLC*, 123 Nev. 228, 162 P.3d 870 (Nev. 2007) (Nevada law) ("Given the Legislature's intent that this court interpret the UFTA in Nevada to conform to other states' interpretations of their respective versions of the UFTA, we conclude that, in order to establish a good faith defense to a fraudulent transfer claim, the transferee must show objectively that he or she did not know or had no reason to know of the transferor's fraudulent purpose to delay, hinder, or defraud the transferor's creditors.").

The exception to this unanimous conclusion as I noted in my prior recommendation is *In re Teleservices Group, Inc.*, 444 B.R. 767, 795 (Bankr. W.D. Mich. 2011), which was concerned with section 548(c) of the Bankruptcy Code rather than the Uniform Fraudulent Transfers Act. In the prior recommendation I thoroughly considered Bankruptcy Judge Hughes' opinion and found that

it was not substantially different from the other courts' holdings. I stated there that a consensus seems to require a three-step analysis to determine a transferee's good faith for purposes of section 548(c) of the Bankruptcy Code. 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. Second, the court must determine whether the transferee undertook a *diligent* inquiry and the results of that inquiry. Third, 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. *Tabor v. Kelly*, 2011 WL 5429095 at *25.

As has been noted by some of the federal courts, section 548(c) of the Bankruptcy Code and section 4(a)(1) of the Uniform Fraudulent Transfers Act should be interpreted consistently. I believe that the three-step analysis that I have outlined captures the essence of what the decisions have indicated is required by an objective standard. The inquiry that is required is whether, given the knowledge that he had, the transferee acted in ways that a reasonable person would act. I believe that this law is sufficiently settled not to require certification to the Tennessee Supreme Court.

> **Plaintiff's Question 6. In a case to set aside fraudulent transfers under Tennessee law, including Tenn. Code Ann. §§ 66-3-101 et seq., when a fraudulent scheme falsely labels transfers as "investment returns," is there any basis for creating the fiction that the fraudulent scheme was a legitimate business enterprise?**

This question is too fact intensive to permit an easy answer. As I noted in response to Defendant's Question 3, the way that the parties treat a particular transfer is important. If the parties account for a transfer as an interest payment only, then the transferor should not be permitted to net the payment against any outstanding indebtedness he claims to be owed. If, on the other hand, the

parties treat a transfer as a payment in reduction of principal, then reasonably equivalent value is given in the form of satisfaction of an antecedent debt.

Kelly seems now to want to treat the payments he received from the Debtor as reductions of principal, and to reduce his outstanding claim accordingly. This, it seems to me, has little bearing on whether the parties operated a "legitimate business enterprise." It seems, rather, to bear on whether the Debtor received reasonably equivalent value in exchange for the transfers to Kelly such that the Debtor's estate was not diminished to the detriment of unsecured creditors. This is a question for the trier of fact.

RECOMMENDATION

I have carefully considered each of the questions raised by the parties and do not believe that any of them is unsettled to an extent that would require or even suggest certification to the Tennessee Supreme Court.