Dated: March 08, 2013
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 PARTIAL SUMMARY JUDGMENT AS TO STATE LAW CLAIMS

BEFORE THE BANKRUPTCY COURT are cross motions for partial summary judgment as to state law claims 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. In a prior recommendation, I stated that as to Count I of the Complaint, the motion of the Trustee for summary judgment should be granted in part and denied in part. I said that summary judgment should be granted in the amount of $8,125 as to the Trustee's claim against the Defendant under 11 U.S.C. § 548(a)(1), but that the motion should be denied as to the Trustee's claim under 11 U.S.C. § 544(b)(1) without prejudice to its being renewed upon proper briefing. Likewise, as to the motion of the defendant to dismiss and for summary judgment, I said that the motion should be denied, pending further briefing. As to Count II of the Complaint, I stated that the motion of the Trustee should be denied and the motion of the Defendant granted. *Tabor v. Kelly (In re Davis)*, 2011 WL 5429095 (Bankr. W.D. Tenn., Oct. 11, 2011).

By order of the United States District Court for the Western District of Tennessee, Judge James D. Todd, Count II of the Complaint was dismissed with prejudice. As to Count I of the Complaint, Judge Todd ordered that the case before him be held in abeyance in order to give the parties the opportunity to renew their motions for summary judgment as to the section 544(b)(1) claim and me the opportunity to make a recommendation on that claim.

The Trustee and the Defendant have now filed new motions for partial summary judgment as to the section 544(b)(1) claim (Dkt. Nos. 67 and 85), together with legal memoranda and the Declarations of Charles Kelly, Mark Bryan, Glen E. Carpenter, Kevin Chaney, Lee Hastings, and Jimmy and Lynda Williams. The parties also rely upon the Depositions of Charles Kelly, Sr.; and the parties' Statement of Undisputed Facts (Dkt. No. 10-1). Attached as exhibits to the Trustee's Supplemental Memorandum are the Deposition of Cecil Ray Davis; a copy of the "Position of Cecil Ray Davis on Sentencing," filed August 10, 2007, in *United States of America v. Davis*, Case 1:07-cr-100002-JDT; copies of Notes payable to Charles Kelly, Sr.; Requests for Admission propounded

by the Trustee to Davis; Answers to the Requests for Admission; and a table that purports to link payments to each of the Notes made payable to Kelly.

I. FACTUAL BACKGROUND

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.

An involuntary petition in bankruptcy was filed against Davis on December 22, 2005. Kelly was one of the petitioning creditors. 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 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 was filed July 6, 2007.

I have previously recommended that the transfers that were made after December 22, 2005, be avoided for the benefit of the bankruptcy estate pursuant to 11 U.S.C. § 548(a)(1)(A). *In re Davis,* 2011 WL 5429095 at *26. Thus at issue in the present motions are the prior transfers in the amount of $46,000.

II. Standard for Granting Summary Judgment

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).

III. ANALYSIS

A. The Trustee's Prima Facie Case

Michael Tabor, the Trustee in Bankruptcy (the "Trustee"), asserts that summary judgment should be granted in his favor on the basis of the guilty plea entered by the Debtor, which the Trustee asserts conclusively establishes that the Debtor operated a Ponzi scheme from December 2001 to December 2005 with the actual intent to defraud his creditors. The Trustee asserts that Kelly received transfers in the total amount of $46,000 as part of the operation of the Ponzi scheme and that these transfers are avoidable under 11 U.S.C. § 544(b)(1) and Tennessee Code Annotated §§ 66-3-101 et seq., 66-3-305, and 66-3-306.

Bankruptcy Code section 544(b)(1) permits a trustee in bankruptcy "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 [United States Code title 11] or that is not allowable only under section 502(e) of this title." 11 U.S.C. § 544(b)(1).

The Trustee seeks to avoid the transfers to Kelly under Tennessee Code Annotated sections 66-3-305(a)(1) which 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 was incurred, if the debtor made the transfer or incurred the obligation:
>
> (1) With actual intent to hinder, delay, or defraud any creditor of the debtor.

Although the Trustee references other theories of relief under Tennessee law, he does so in a catch-all fashion, i.e., "these transfers are avoidable under Tenn. Code Ann. §§ 66-3-101 et seq., 66-3-305, and 66-3-306." The Trustee has made no effort to present proof or argument in support of any theory other than actual fraud under section 66-3-305(a)(1). Section 66-3-101 on its face applies to "every gift, grant, conveyance of lands, tenements, hereditaments, goods, or chattels, or of any rent, common or profit out of the same," not to payments of money; and section 66-3-306 applies only with respect to creditors existing at the time of the relevant transfer. Section 66-3-305(a)(2) is a possible avenue of recovery for the Trustee, but he has not attempted to establish the Debtor's financial position at the time of the relevant transfers. Summary judgment should be granted to the Defendant Kelly with respect to these alternative theories of recovery.

In order to succeed under section 66-3-305(a)(1), the Trustee must prove the following:

(1) a transfer made or incurred,

(2) by a debtor,

(3) with actual intent to hinder, delay, or defraud any creditor of the debtor, and

(4) the existence of an [unpaid] creditor whose claim arose before or after the transfer was made.

The Trustee must also show that the transfers occurred within the applicable reach-back period, which is four years from the date of the transfer. Tenn. Code Ann. § 66-3-310(1). There is no dispute that transfers were made by Davis, a debtor, to Kelly, a creditor, within the applicable period. Kelly does dispute that the transfers were made with actual intent to hinder, delay, or defraud a creditor, and Kelly does dispute the existence of an unpaid creditor whose claim arose before or after the transfer was made. In addition, as an affirmative defense, Kelly claims that he received the transfers from Davis in good faith and for a reasonably equivalent value. *See* Tenn. Code Ann. § 66-3-309(a).

(1) Intent to Hinder, Delay or Defraud

In order to prove Davis's intent to hinder, delay or defraud, the Trustee has introduced evidence of Davis's Plea Agreement, pursuant to which Davis pled guilty to a two-count Information that described Davis's perpetuation of a Ponzi scheme from on or about 2001 until October 2005. As stated in my prior Proposed Findings of Fact and Conclusions of Law as to Cross Motions for Summary Judgment, if admissible, this evidence gives rise to a "Ponzi scheme presumption," a presumption that actual intent to defraud is present where a Ponzi scheme is established. "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." *Picard v. Merkin, et al. (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. Kelly argues that the guilty plea is not admissible under Tennessee law, and that even if it is, the Debtor's guilty plea does not conclusively establish actual fraud.

Kelly argues that under Tennessee law a guilty plea is not admissible for two reasons. First, he says that the guilty plea is not admissible in a civil action to which the one making the admission of guilt is not a party. Here Kelly relies upon *Inter-City Trucking Co. v. Mason & Dixon Lines, Inc.,* 276 S.W.2d 488, 491 (Tenn. Ct. App. 1955). Kelly is correct in stating the position of the Tennessee Court of Appeals:

> While there are decisions to the contrary, we think that a former plea of guilty in a criminal case is not admissible in evidence in a civil case where the pleader is not a party defendant to the civil case.

276 S.W.2d at 491. This decision predates the adoption of the Federal and Tennessee Rules of Evidence, however, and does not appear to be controlling in this adversary proceeding for reasons discussed below.

Second, Kelly argues that although evidence of a guilty plea may be admitted under Rule 803(22) of the Federal Rules of Evidence, Rule 803(22) of the Tennessee Rules of Evidence differs from the federal rule in a material way. The federal rule expressly permits the introduction of a guilty plea:

> (22) *Judgment of a Previous Conviction.* Evidence of a final judgment of conviction [is not excluded by the rule against hearsay, regardless of whether the declarant is available as a witness] if:
>
> > (A) the judgment was entered after a trial or guilty plea, but not a nolo contendere plea;
> >
> > (B) the conviction was for a crime punishable by death or by imprisonment for more than a year;
> >
> > (C) the evidence is admitted to prove any fact essential to the judgment; and

> (D) when offered by the prosecutor in a criminal case for a purpose other than impeachment, the judgment was against the defendant.
>
> The pendency of an appeal may be shown but does not affect admissibility.

F.R.E. 803(22). The Tennessee rule, on the other hand, provides an exception from the rule excluding hearsay for:

> (22) *Judgment of a Previous Conviction.* Evidence of a final judgment adjudging a person guilty of a crime punishable by death or imprisonment in excess of one year to prove any fact essential to sustain the judgment, but not including, when offered by the prosecution in a criminal case for purposes other than impeachment, judgments against persons other than the accused. The pendency of an appeal may be shown but does not affect admissibility.

T.R.E. 803(22). The Advisory Committee Comment notes: "The rule adopts the federal approach admitting felony conviction records to prove underlying facts necessary to the judgment," but goes on to say, "The Commission believed that a jury's finding beyond a reasonable doubt that a serious crime was committed should be admitted in a later civil or criminal trial to prove the underlying facts necessary to the judgment of conviction." Kelly asserts that under the Tennessee rule introduction of a prior judgment that resulted from a guilty plea rather than a trial by jury is not permitted.

Underlying Kelly's argument is the assertion that the court should apply the Tennessee rule to this adversary proceeding because state law provides the rule of decision. Rule 1101 of the Federal Rules of Evidence, however, clearly provides that the federal rules apply to proceedings before United States district courts and bankruptcy judges. There is one exception to this general rule. Rule 501 provides that "in a civil case, state law governs the privilege regarding a claim or defense for which state law supplies the rule of decision." No similar exception is provided in Rule 803. The Federal Rules of Evidence apply to this adversary proceeding. Therefore evidence of the

Debtor's guilty plea is admissible to prove the underlying facts necessary to the criminal judgment. *See Rosen v. Neilson (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.

In my prior Proposed Findings and Conclusions, I discussed the effect to be given the guilty plea in this subsequent civil proceeding at some length. *See In re Davis*, 2011 WL 5429095 at *17-19. Those findings and conclusions are incorporated herein. To briefly summarize, I found that the admission of the guilty plea does not preclude Kelly from relitigating the issue of "actual intent to hinder, delay or defraud creditors" in this bankruptcy proceeding because he had no opportunity to participate in the prior criminal proceedings. I further found, however, that Davis pled guilty to Counts 1 and 2 of the criminal Information, which charges, among other things, that:

> It was a 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.

See Exs. A and C to the Trustee's Motion for Summary Judgment, Dkt. No. 10. This is consistent with the definition of a Ponzi scheme adopted by the court of appeals: A Ponzi scheme is "a fraudulent investment scheme in which money contributed by later investors is used to pay artificially high dividends to the original investors, creating an illusion of profitability, thus

attracting new investors." *Ades-Berg Investors v. Breeden (In re Bennett Funding Group, Inc.),* 439 F.3d 155, 157, n.2 (2nd Cir. 2006), citing *Black's Law Dictionary* 1198 (8th ed. 2004).

Notwithstanding the clear statements in the Information, Kelly argues that Davis did not plead guilty to operating a Ponzi scheme, but rather pled guilty to two counts of mail fraud. Kelly is simply mistaken. While it is true that Davis pled guilty to two counts of mail fraud, the Information clearly charges that Davis set up a Ponzi scheme and further charges numerous facts that are consistent with the operation of a Ponzi scheme. These facts were necessary to the criminal judgment, and his guilty plea is an admission of them. Kelly argues that the specificity of the Information shows that the court should not rely upon the guilty plea. Kelly points to other related adversary proceedings in which the Trustee asserted that any conversation he had with the U.S. Attorney's office was protected from discovery by the attorney-client privilege or work product doctrine. He intimates that the Trustee cooperated with the U.S. Attorney to draft the information and guilty plea in such a way as "to save the Trustee the trouble of having to prove Debtor's purported fraud." Dkt. No. 85, fn. 1. Kelly did not, however, file a similar discovery request in his own case and offers no proof that the drafting of the Information was influenced in some way by the Trustee. It is equally possible that the Trustee was influenced by the language of the Information.

The question remains whether there is a genuine issue of fact as to whether Davis was operating a Ponzi scheme. Kelly argues in his Response to the Trustee's Supplemental Memorandum that whether or not Davis was operating a Ponzi scheme remains an open question which should be presented to the jury. The only proof that he offers, however, is in the form of the deposition testimony of the Debtor. Kelly argues that the jury should consider these statements to

determine whether the Debtor was in fact operating a Ponzi scheme notwithstanding the admission that he was in his Guilty Plea. Kelly Response, Dkt. No. 123, pp. 3-7.

In support of his position that the Debtor should be permitted to testify in contradiction to the Guilty Plea, Kelly relies upon *In re James M. Cannon Family Trust*, 2012 WL 5993736 (Tenn. Ct. App. Nov. 30, 2012). In that case the plaintiff alleged that the defendant killed her (the defendant's) husband and therefore forfeited all rights under a trust the husband had created. After the complaint was filed, the defendant was convicted of first degree murder in the death of her husband. The plaintiff filed a motion for summary judgment in the civil suit supported by the judgment of conviction and the underlying indictment. The defendant filed an affidavit in the civil proceeding in which she maintained that she did not kill her husband. The trial judge admitted the affidavit but found that the defendant's statement of her innocence was not material. On appeal, the plaintiff argued that the trial court was correct in disregarding the affidavit as it contained no more than a "conclusory" proclamation of innocence. The appellate court reversed and remanded, holding that the affidavit, taken in the light most favorable to the defendant, raised a genuine issue of fact.

Although somewhat similar to the present case, the facts in *James M. Cannon Family Trust* may be distinguished in one materially important way: The defendant in that case maintained her innocence throughout the criminal proceeding and all related civil proceedings. She was nonetheless convicted of first degree murder after a jury trial. In Davis's case, he entered a plea agreement in which he admitted the facts contained in the underlying Information, including admissions that he engaged in a fraudulent scheme, specifically a Ponzi scheme. Davis should not be permitted to contradict these statements in the context of this civil proceeding.

In the Sixth Circuit, "[t]he doctrine of judicial estoppel bars a party from (1) asserting a position that is contrary to one that the party has asserted under oath in a prior proceeding, where (2) the prior court adopted the contrary position 'either as a preliminary matter or as part of a final disposition.'" *Longaberger v. Kolt*, 586 F.3d 459, 470 (6th Cir. 2009), quoting *Browning v. Levy,* 283 F.3d 761, 775 (6th Cir. 2002), and *Teledyne Indus., Inc. v. NLRB*, 911 F.2d 1214, 1218 (6th Cir. 1990). The doctrine is to be applied with caution, however, "to avoid impinging on the truth-seeking function of the court because the doctrine precludes a contradictory position without examining the truth of either statement." *Longaberger,* 586 F.3d at 470, quoting *Teledyne Indus.,* 911 F.2d at 1218. The law is similar in the state courts of Tennessee: "Pursuant to the doctrine of judicial estoppel, a party will not be permitted to take a position that is directly contrary to or inconsistent with a position previously taken by the party where the party had or was chargeable with full knowledge of the facts and where the conduct would prejudice another." *Watson v. Watson*, 309 S.W.3d 483, 497 (Tenn. Ct. App. 2009), quoting *Guzman v. Alvares*, 205 S.W.3d 375, 382 (Tenn. 2006). Davis was a party in the underlying criminal case, and he is a material witness in this proceeding and the debtor in bankruptcy whose estate is being administered. Even if judicial estoppel does not strictly apply in the pending civil proceeding because Davis is not a party, his admissions are nonetheless binding: "Admissions–in a guilty plea as elsewhere–are admissions. *Scholes v. Lehmann,* 56 F.3d 750, 762 (7th Cir. 1995) (Ponzi-scheme operator/witness not permitted to retract admissions in plea agreement by subsequent affidavit in support of motion for summary judgment).

Further, nothing in Davis's Rule 2004 examination is inconsistent with the operation of a Ponzi scheme. Although the Debtor operated some businesses, none of them was profitable. Debtor's February 23, 2007 Rule 2004 Exam, Docket No. 122-1, pp. 14-22. He did not keep

corporate records for the various businesses. *Id*., p. 22. The loans of Davis's numerous "customers" were personal loans to him, not to any of his corporations. *Id*. He used the money for whatever account he needed: "[M]ost every time I would tell people, I'd say this is a personal loan to me, I use it for different things, whatever, you know, and they'd say, oh, we don't care, throw it in the air, you know, as long as we get our money." *Id*., p. 23. During the period 2001 through 2003, he paid interest in the 23-30% range, a much greater return than an investor could have gotten at a bank. *Id*., p. 33. He had a person, Don White, who sent him a lot of people. When he did this, Davis would "up his interest five points." *Id*., p. 35. Although Davis claimed that he did not know what a Ponzi scheme was at the time, he nevertheless reconfirmed the truth of the statements in his plea agreement: "I didn't recognize it as a Ponzi scheme, but I pled guilty. Yes, if that's what it was. You know, I've got to take responsibility." *Id*., p. 37. Given these additional admissions, there is simply no evidence creating a genuine issue of material fact concerning the existence of a Ponzi scheme. *See Rosen v. Neilson (In re Slatkin)*, 310 B.R. 740, 749-50 (C.D. Cal. 2004) (Excerpts from debtor's deposition did not create a triable issue of fact as to the debtor's fraudulent intent, but merely bolstered statements in the plea agreement).

In addition to proving the existence of the Ponzi scheme, the Trustee has introduced evidence that establishes that the transfers made by the Debtor and received by Kelly during the period covering the perpetration of the Ponzi scheme were made in furtherance of the scheme. He provided copies of promissory notes made payable to Kelly and checks received by him. Supplemental Memorandum Providing Facts Responsive to Questions of the Court Concerning the Trustee's Motion for Summary Judgment as to State Law Claims, Dkt. No. 122, Exs. D, E, F. Kelly supplied

copies of these same notes[1] and has admitted receiving the disputed checks in payment of these loans. Kelly Decl. at ¶¶ 9-10. These notes reflect unusually high rates of interest, consistent with the Debtor's testimony about his lending practices. The notes and payments may be reconstructed as follows:

Note Date	Note Amount	Interest Due	Interest Amount	Payment Received	Date
05/04/02	20,000	05/04/03	7,000	7,000	05/30/03
05/04/03	renewal	05/04/04	5,000	5,000	05/07/04
05/04/04	renewal	05/04/05	5,000		
05/04/05	renewal	05/04/06	5,000		
05/05/02	40,000	05/05/03	14,000	14,000	05/30/03
05/04/03	renewal	05/04/04	10,000	10,000	05/21/04
05/04/04	renewal	05/04/05	10,000		
05/04/05	renewal	05/04/06	10,000		
09/02/04	60,000	12/02/04	3,750	3,750	12/13/04
		03/02/05	3,750	1,875*	03/18/05
		06/02/05	3,750		
		09/02/05	3,750		
09/03/04	100,000	12/03/04	6,250	6,250*	12/17/04
		03/03/05	6,250	3,125*	03/11/05

[1] Kelly did not produce a copy of the final note for $18,000. For purposes of this analysis, the court included this note because it is consistent with Kelly's earlier statements that he loaned Davis $268,000. He has subsequently maintained that he loaned only $250,000. No payments are recorded to have been made with respect to the $18,000 note, so whether it is included or not is immaterial.

				3,125*	03/15/05
		06/03/05	6,250		
		09/03/05	6,250		
11/18/04	30,000	12/30/04	3,000		
12/31/04	renewal	01/31/05	3,000		
01/31/15	renewal	04/31/05	3,000		
05/04/05	18,000	06/30/05	2,000		
06/30/05	renewal	09/30/05	2,000		
TOTALS	268,000			54,125	

* indicates a post-dated check.

This is my reconstruction, not the Trustee's or Kelly's, but it is consistent with Kelly's initial brief in support of his motion for summary judgment in which he maintained that, "He invested $268,000.00 and was returned $54,125, which was interest only." Dkt. 16, p. 3. It is also consistent in matching payment amounts with interest amounts and due dates. Not all payments were made precisely on their due dates, and some payments appear to have been half payments, but it is fairly easy to match notes with payment amounts. Kelly has never argued that the payments that he received from Davis were anything other than interest payments on account of loans he made to Davis. If it is accepted that Davis was operating a Ponzi scheme, there is no genuine issue of material fact that the payments received by Kelly were made pursuant to that scheme.

These facts – the existence of a Ponzi scheme and payments made in furtherance of it – give rise to the presumption that the Debtor acted with actual intent to defraud creditors. *See Picard v.*

Merkin, et al. (In re Bernard L. Madoff Inv. Securities, LLC), 2011 WL 3897970, *4 (S.D.N.Y. 2011) ("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."); *Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 11 (S.D.N.Y. 2007). This presumption is an additional "badge of fraud," if you will, which establishes actual intent to defraud for purposes of the Bankruptcy Code and the Uniform Fraudulent Transfer Act. The Trustee has made the appropriate showing with respect to the third element of a fraudulent transfer. He need do no more, such as provide a forensic accounting as suggested by Kelly. Instead it is up to Kelly to come forward with evidence to rebut the presumption enjoyed by the Trustee. In the face of the overwhelming evidence that the Debtor operated a Ponzi scheme and that transfers to Kelly were made pursuant to that scheme, Kelly has failed to raise a genuine issue for trial with respect to the Debtor's intent.

(2) Existence of a Creditor with an Allowable Unsecured Claim

Kelly's second argument is that the Trustee has not alleged or demonstrated the existence of a creditor holding an allowable unsecured claim at the time of each of the transfers to Kelly. Kelly asserts that under section 544(b) of the Bankruptcy Code, the Trustee must allege and prove that at the time of each transfer there was, in fact, a creditor in existence who now holds an allowable unsecured claim under section 502 of the Code. Kelly relies upon a decision of the Bankruptcy Appellate Panel for the Sixth Circuit, *Lyon v. Eiseman, et al. (In re Forbes)*, 372 B.R. 321 (BAP 6th Cir. 2007). That decision, quoting from a decision of the Bankruptcy Court for the Eastern District of Tennessee, does seem to imply that the creditor upon whose claim the trustee in bankruptcy relies must have had a claim at the time of the transaction. This seems to be in error,

however. The decision relied upon by the Panel, *Parlon v. Claiborne, et al. (In re Kaylor Equip. & Rental, Inc.),* 56 B.R. 58 (Bankr. E.D. Tenn. 1985), was a decision in which section 544(b) claims were not pursued at trial. Thus the language quoted by the Panel is merely dicta and varies from the plain language of the statute, which requires only that there be "a creditor holding an unsecured claim that is allowable" under the Bankruptcy Code. 11 U.S.C. § 544(b)(1). The Panel in *Forbes* also relied upon the decision of anther panel of the BAP, *Belfance v. Bushey (In re Bushey),* 210 B.R. 95 (BAP 6th Cir. 1997), which clearly states that section 544(b) requires proof of four elements:

1. A creditor
2. Holding an allowable unsecured claim; and
3. A transfer of an interest of the debtor in property,
4. That is avoidable under applicable law.

Bushey, 210 B.R. at 100. All that is required for the trustee in bankruptcy to have standing under section 544(b) is that there be some creditor of the bankruptcy estate with an allowable unsecured claim. *Id. See also Leibovitz v. Parkway Bank & Trust Co. (In re Image Worldwide, Ltd.),* 139 F.3d 574, 576-77 (7th Cir. 1998) ("[U]nder the strong-arm provision of the Bankruptcy Code, 11 U.S.C. § 544(b), the trustee can avoid any transaction of the debtor that would be voidable by any actual unsecured creditor under state law."); 5 Collier on Bankruptcy, ¶ 544.06[1] (Alan N. Resnick & Henry J. Sommer (16th ed.2012)) ("Under section 544(b)(1), the trustee succeeds to the rights of an unsecured creditor in existence at the commencement of the case who may void the transfer under applicable law."). According to the *Bushey* Panel, "Section 544(b) imposes only one 'standing' requirement that is independent of the state law cause of action asserted by the trustee: the creditor

must hold an allowable unsecured claim, determined under the allowance rules of the Bankruptcy Code." *Bushey*, 210 B.R. at 101. If there is such a creditor, "the first and second elements of § 544(b) are satisfied and the inquiry shifts: Would the creditor have standing under 'applicable law' to prosecute the avoidance action brought by the trustee?" *Id.* Kelly's argument that the Trustee must prove that there was a creditor in existence at the time of each transfer must fail to the extent that the Trustee relies exclusively upon actual fraud, Tennessee Code Annotated section 66-3-305(a)(1). That section applies whether the creditor's claim arose before or after the transfer. *See* Tenn. Code Ann. § 66-3-305(a).[2]

The Trustee must also demonstrate the existence of a creditor holding an unsecured claim allowable under the Bankruptcy Code. I have carefully reviewed the original complaint and the second motion for summary judgment. There is no allegation that squarely meets the first two requirements for sustaining a cause of action under section 544(b)(1). The Trustee comes closest to making the required allegation when he states, "The payments and/or transfers are avoidable under Tennessee law, including without limitation Tenn. Code Ann. §§ 66-3-101 et seq., 66-3-305 and 66-3-306, because they are fraudulent as to creditors of the Debtor, which hold unsecured claims

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[2] Kelly's argument also must fail to the extent, if any, that the Trustee relies upon constructive fraud as described in Tennessee Code Annotated section 66-3-305(a)(2). Section 66-3-305(a) applies to that cause of action as well, and it may be maintained whether the creditor's claim arose before or after the transfer. The cause of action set out at Tennessee Code Annotated section 66-3-306, however, is available only to creditors whose claims arose *before* the targeted transfer was made or obligation was incurred. Tenn. Code Ann. § 66-3-306(a). Thus, Kelly correctly argues that the Trustee may not maintain a claim under Tennessee Code Annotated section 66-3-306(a) unless he is able to show that there was a creditor in existence at the time of the disputed transfers who was also a creditor at the time the bankruptcy case was commenced. As I have already said, the Trustee has not pursued claims under §§66-3-305(a)(2) or 66-3-306(a), and summary judgment should be granted to Kelly on those claims.

in this case allowable under 11 U.S.C. § 502." Complaint, ¶ 25, Dkt. No. 1. Kelly has not directly contested the existence of such creditors, and Schedule F filed in the underlying bankruptcy case reflects numerous unsecured creditors. The Trustee has shown that if other requirements are met, there are creditors who could avoid certain transfers made to Kelly under applicable state law. Therefore, the Trustee has standing to proceed under Section 544(b)(1) of the Bankruptcy Code.

The Trustee has established a prima facie case for fraudulent transfer based on actual intent to defraud under Tennessee Code Annotated § 66-3-305(a)(1). I now turn to the objections and affirmative defense raised by Kelly.

(B) Kelly's Objections and Affirmative Defense

Kelly argues that the Trustee's motion should be denied and his motion should be granted for five additional reasons. He argues:

> (1) As a matter of Tennessee law, the Trustee's theory that creditors knew or should have known of Debtor's fraud is fatal to the Trustee's state law claims;
>
> (2) The Trustee must demonstrate that each transfer to Kelly was fraudulent;
>
> (3) Kelly had no knowledge of Debtor's fraud as required under Tennessee law;
>
> (4) Kelly received transfers from Debtor in good faith and for reasonably equivalent value;
>
>> (a) Kelly had no actual or constructive knowledge of Debtor's fraud, and therefore received the transfers from Debtor in good faith.
>>
>> (b) Kelly received the transfers for reasonably equivalent value.

I will consider each of these arguments in turn.

(1) Knowledge of Ponzi Participants Not Imputed to Trustee

Kelly's first argument is that under Tennessee law a conveyance may not be attacked by subsequent creditors who had actual or constructive knowledge of a prior conveyance made with

fraudulent intent because they cannot be regarded as hindered, delayed, or defrauded by such transfers. Kelly relies upon the decision of the Tennessee Court of Appeals in *Ledford v. Lee*, 200 S.W.2d 393, 397 (Tenn. Ct. App. 1946). In that case a man who handled the financial affairs of his father and knew about certain deeds made by his father to his brothers was estopped from attacking the conveyances to his brothers after their father's death. The court quoted with approval the following:

> 'Creditors who have contracted debts under such circumstances that knowledge of previous voluntary transfer must be imputed to them cannot be regarded as hindered, delayed or defrauded by such transfers, and therefore, they may not attack such conveyances for the purpose of obtaining collection of their debts.'

Id. at 397, quoting 24 Am.Jur., page 287, section 145. Kelly argues that if persons who did business with the Debtor knew or should have known of the Debtor's fraudulent activity based upon the terms upon which the Debtor did business then that knowledge should be imputed to the Trustee preventing him from recovering from Kelly. The argument assumes that all creditors of the bankruptcy estate made personal loans to the Debtor under terms similar to those offered to Kelly, and thus that no creditor could serve as the triggering creditor for the Trustee under section 544(b)(1). There is simply no proof offered by Kelly that this is the case, and the Debtor's Schedule F names a number of "garden variety" creditors such as credit card issuers.

(2) Trustee Need Not Prove Each Transfer Fraudulent

Kelly next argues that the Trustee must demonstrate that each transfer to Kelly was fraudulent. Kelly's argument ignores the Ponzi scheme presumption which arises under the facts presented by the Trustee in this case. Under the Ponzi scheme presumption, all transfers made by the debtor during the applicable period are presumed to be made with actual intent to defraud creditors. It is up to the Defendant to show that transfers to him were not made in furtherance of the

scheme. He has not done so; in fact, the evidence fairly clearly establishes that they were made in furtherance of the scheme.

(3) Trustee Need Not Prove Knowledge of the Debtor's Fraudulent Scheme

Kelly next argues that he had no knowledge of Debtor's fraud as required under Tennessee law. Kelly relies upon a decision of the Tennessee Court of Appeals from 1929, a decision that predates the enactment of the Uniform Fraudulent Transfer Act in Tennessee. *First National Bank of Centreville v. Wilkins,* 11 Tenn. App. 9, 14-15 (Tenn. Ct. App. 1929). Under prior law, the Uniform Fraudulent Conveyance Act, a defendant was not required to return property allegedly fraudulently conveyed to him if he could show that he was a "purchaser for fair consideration without knowledge of the fraud at the time of the purchase." Uniform Fraudulent Conveyance Act of 1919, chapter 125, section 9. In application, however, the inquiry that was made under prior law included what the transferee knew or *should have known*:

> If a transfer is for a valuable consideration, creditors cannot attack it because of the fraudulent intent of the grantor, where the grantee had neither (1) actual notice of such intent, nor (2) notice of any fact or facts calculated to put him on inquiry and which would lead to discovery of such intent, nor (3) participated in fraud.

First Nat'l Bank of Centreville, 11 Tenn. App. 9, 1929 WL 1680, at *5, quoting 27 C.J., 506, sec. 175. Under current law, effective July 1, 2003, a transferee must prove that he took the transfers "in good faith and for a reasonably equivalent value." Tenn. Code Ann. § 66-3-309. The Tennessee Supreme Court has not ruled on the question whether the change in the law – from "without knowledge of the fraud" to "in good faith" – worked a change in the standard to be applied. Kelly argues, based on *Stone v. Smile*, 2009 WL 4893563 (Tenn. Ct. App. 2009), that the badges of fraud and good faith are to be considered from the *transferee's* point of view. He asserts that this amounts to a subjective test.

Kelly is only partially correct. Actual intent is determined from the debtor's point of view, while good faith (a defense) is considered from the transferee's point of view. The *Stone* panel described the proper inquiry as one into what the transferee "knew *or should have known*," the same inquiry directed to be undertaken by the court in *First Nat'l Bank of Centreville. Stone,* 2009 WL 4893563 at *6. This is the type of inquiry that I suggested should be used in evaluating good faith under section 548(c) of the Bankruptcy Code, and starts with an inquiry into what Kelly actually knew that should have caused him to make inquiry into Davis's solvency or fraud. *See Farinash v. Bensusan (In re Prebul Jeep)*, 2009 WL 4581900, at *3 (Bankr. E.D. Tenn. 2009), citing *Creditor's Comm. of Jumer's Castle Lodge, Inc. v. Jumer,* 472 F.3d 943, 947 (7th Cir. 2007) (Tennessee's avoidance provisions derive from the Uniform Fraudulent Transfer Act..., a model statute so closely resembling §548 [of the Bankruptcy Code] that the two are generally construed in consonance.").

It is true that the transfers at issue in this case occurred both before and after the effective date of the Uniform Fraudulent Transfer Act, but Kelly is incorrect in asserting that Tennessee law requires proof that the transferee had actual knowledge of the fraud in order for a creditor to prevail on an actual fraud theory.

(4)(a) Kelly has Not Conclusively Proved His Good Faith

Finally Kelly turns to the affirmative defense provided at Tennessee Code § 66-3-309. That section provides: "A transfer or obligation is not voidable under § 66-3-305(a)(1) against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee." Kelly, as an initial transferee, has the burden of establishing each of these elements.

See, e.g., Plotkin v. Pomona Valley Imports, Inc., et al. (In re Cohen), 199 B.R. 709, 718 (BAP 9th Cir. 1996).

Kelly argues that he took the transfers in good faith because he had no knowledge of the Debtor's scheme to defraud. "Good faith" is not defined in the Uniform Fraudulent Transfer Act, nor does there appear to be any case that specifically construes this requirement under Tennessee law. *Black's Law Dictionary* states that the term includes not only "honest belief, the absence of malice and the absence of design to defraud or to seek an unconscionable advantage," but also "freedom from knowledge of circumstances which ought to put the holder on inquiry." *Black's Law Dictionary* at 693 (6th ed. 1990), quoted in *Jobin v. McKay (In re M & L Business Machine Company, Inc.*), 84 F.3d 1330, 1335 (10th Cir. 1996). The question of good faith requires a determination of whether the facts satisfy the proper legal standard, a mixed question of law and fact, but primarily a question of fact. *Id.* at 1338.

Under federal law, the majority of courts in interpreting Bankruptcy Code § 548(c) apply an objective standard: the court must 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 the original). On the other hand, there are no Tennessee cases defining "good faith" for purposes of the Uniform Fraudulent Transfer Act. In another commercial setting, however, the Tennessee Supreme Court has said that, "A buyer is not considered a good faith purchaser if he had 'notice of facts that would put a reasonably prudent man on inquiry.'" *Liles Bros. & Son v. Wright*, 638 S.W.2d 383, 386 (Tenn. 1982) (quoting 67 Am.Jur.2d *Sales* § 268). Kelly has argued that a different approach may be required at least as to those

transfers that occurred before the effective date of the Tennessee Uniform Fraudulent Transfer Act, Jul 1, 2003. As discussed elsewhere in connection with Kelly's argument that the Trustee must prove that he had knowledge of Davis's fraudulent intent, I am not convinced that there is a real distinction in how good faith is evaluated under the Uniform Fraudulent Conveyance Law and the Uniform Fraudulent Transfer Act. Both require an inquiry into what the defendant knew or should have known that should have apprised him of the transferor's fraudulent intent.

In my prior proposed findings, I suggested that a hybrid test involving a three-step inquiry should be made: first, what did the transferee actually know that would suggest insolvency or a fraudulent purpose with respect to the transferor? Second, did the transferee undertake a diligent inquiry into the possible insolvency or fraud? Third, if diligent inquiry did not discover the fraud, would any reasonable investigation have disclosed the insolvency or fraud? *In re Davis,* 2011 WL 5429095, at *25.

In support of his good faith defense, Kelly points to the following facts:

> 1. Charles Kelly and other investors began doing business with Debtor on the strength of his long-term business success, his character, and his reputation in the community. Declaration of Lee Hastings ("Hastings Decl.") at ¶¶ 2 through 8; Declaration of Kevin Chaney ("Chaney Decl.") at ¶¶ 2 through 7; Declaration of Charles Kelly ("Kelly Decl.") at ¶¶ 2 through 7, 9; Declaration of Glen Carpenter ("Carpenter Decl.") at ¶ 4; Affidavit of Robert Newbill, Docket No. 16-1; and Affidavit of Kay French, Docket No. 16-2.
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> 2. Investors personally observed vending machines at Debtor's warehouse and in operation at various locations throughout the time they did business with the Debtor. Bryan Decl. at ¶ 3; Hastings Decl. at ¶ 6; and Chaney Decl. at ¶¶ 2 and 6.
>
> 3. Lee Hastings personally traveled to the Philippines with Debtor to view vending machine manufacturing and furniture production there and reported his observations to other investors. Hasting Decl. at ¶ 7; Kelly Decl. at ¶ 17; and Chaney Decl. at ¶ 17.

> 4. Debtor had a warehouse and retail store in Milan, Tennessee, from which he sold furniture and other items to the public. Carpenter Decl. at ¶ 4; Chaney Decl. at ¶¶ 6 and 7; Hastings Decl. at ¶ 5; Kelly Decl. at ¶ 18; Affidavit of Lynda and Jimmy Williams ("Williams Aff.") at pp.1-2 and Docket No. 41-8 at pp. 15-27.
>
> 5. Kelly had no reason to be concerned about Debtor's business practices or operations until early 2005. Kelly Decl. at ¶ 21. See also Hastings Decl. at ¶¶ 11 through 15; Bryan Decl. at ¶ 17; Carpenter Decl. at ¶ 7; Chaney Decl. at ¶¶ 8 through 10.
>
> 6. After Kelly asked Debtor whether he was running a Ponzi scheme, investors received a letter from Debtor's attorney dated August 12, 2005, explaining that Debtor was experiencing temporary cash flow problems and giving assurances that Debtor had several viable income-producing businesses from which he intended to repay investors. Kelly Decl. at ¶ 23. See also Hastings Decl. at ¶ 15 and Chaney Decl. at ¶ 19.
>
> 7. In follow-up to this letter, Debtor sent a letter to investors dated October 18, 2005, again assuring that he intended to repay investors from the long-term consistent cash-flow from his existing businesses. Kelly Decl. at ¶ 24 and Chaney Decl. at ¶ 10.

Memorandum of Facts and Law in Response to Trustee's Motion for Partial Summary Judgment as to State Law Claims and in Support of Defendant Charles Kelly, Sr.'s Cross-Motion for Summary Judgment, Dkt. No. 86, pp. 3-4. The transfers at issue with respect to the pending motions occurred between 2001 and December 22, 2005. Good faith is to be determined at the time of the transfer. Any events that occurred after December 22, 2005, such as the receipt of letters from the Debtor and his counsel, are irrelevant to the present inquiry.

In opposition, the Trustee points to the following facts that Kelly actually knew to demonstrate his lack of good faith:

> 8. [Kelly] 'invested with Davis because friends told him that Davis was paying them a return of twenty-five to thirty percent on their investments with him. Kelly Dep., pp. 9-11.
>
> 9. Before investing with Davis, Kelly got no financial statements from Davis, did not run a credit check on him. Kelly Dep., p. 12. He got no balance sheets or financial records from Davis. Kelly Dep., p. 18.

10. Other investments Kelly had were earning eleven percent, twelve percent, and seventeen percent. Kelly Dep., p. 14.

11. Kelly had invested in mutual funds, stocks, and retirement accounts over a period of thirty years. Kelly Dep., p. 16.

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

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

14. In November 2004, Kelly lent Davis $30,000 for six weeks. It earned $3,000 of interest, or a rate of 80% or 90% interest per annum. Kelly Dep., pp. 35-36.

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

16. Kelly admits that what Davis told him about how he was able to pay that kind of interest "hindsight-wise" strikes him as funny or something that bore some investigation. Kelly Dep., p. 50.

17. Kelly admits that he got suspicious that Davis was running a Ponzi scheme. Kelly Dep., p. 83.

Memorandum of Facts and Law in Support Trustee's Motion for Summary Judgment on State Law Claims, Dkt. 67, Attachment 1, pp. 4-5.

In the context of these motions for summary judgment, the court is not to weigh the evidence, but must consider each motion in turn to determine whether there are genuine issues of material fact that require trial. In response to Kelly's motion for summary judgment, the court must consider the evidence in the light most favorable to the Trustee. The Trustee has pointed to a number of facts that raise questions about Kelly's good faith in this case. As the Trustee notes, Kelly was not an insider, but he was an experienced investor and an attorney. He knew that he was not simply making personal loans to a friend, but that he was investing his money with Davis in the expectation of receiving returns substantially higher than what he was receiving from his more conventional investments. He knew that there were a number of other persons who had invested their money by

making similar loans to Davis. He asked for no collateral, nor did he inquire about the use to which the loans would be put. One of the transfers he received was made with a post-dated check. These facts taken together should have led Kelly to make a diligent inquiry into Davis's financial situation or to have avoided these "investments" altogether.

In response to the Trustee's motion for summary judgment, however, the court should view the evidence in the light most favorable to Kelly. He insists that he had no knowledge of the Debtor's fraudulent scheme and no reason to inquire beyond the face of the transactions based on his inquires about the Debtor in the community, the investigation conducted by Lee Hastings and himself, and his prior experience with the Debtor before the beginning of the Ponzi scheme period.

The question of Kelly's good faith is a question of material fact about which there are genuine issues that should be submitted to the jury.

(4)(b) Kelly Has Proved Reasonably Equivalent Value

In order to be successful on his affirmative defense, Kelly must show not only that he acted in good faith, but that he gave reasonably equivalent value for the disputed transfers. Kelly belatedly argues that he did give reasonably equivalent value for the transfers he received in the form of reductions to the principal amount of his loans. This is in direct conflict to his prior insistence that the payments he received were "interest only." Kelly now argues that, "the payments to Kelly did not deplete the Debtor's net worth because they were either payments on account of an antecedent debt or, if Debtor induced Kelly to invest in a fraudulent scheme, as the Trustee contends, then the payments proportionally reduced Kelly's restitution claim against Debtor." Kelly Memorandum, Dkt. No. 86, p. 15. Kelly claims that he treated the payments received from Davis as a reduction of principal for tax purposes, and he attaches Form 1040 Schedule B for 2004 and

2005 showing no interest income from Davis. Although he correctly states that the Internal Revenue Service permits a taxpayer to recognize a theft loss resulting from a fraudulent investment, he does not show that he actually claimed this loss nor does he show that his claim was included in the overall restitution sentence at the lower amount. *See* IRS Rev. Rul. 2009-9 (IRS RRU), 2009-14 I.RB. 735 (IRS RRU), 2009 WL 678990 at *4.

There is no dispute that the transfers Kelly received were on account of an antecedent debt. Under section 66-3-304 of the Tennessee Code, value is given when an antecedent debt is secured or satisfied. There is also no dispute that Kelly received less than he loaned to or invested with Davis. Based upon the Trustee's records, he loaned $268,000 and received $54,125. Based on Kelly's records he loaned $250,000 and received $54,125. The remaining question is whether these payments were given for value.

Because there does not appear to be a Tennessee case dealing with the question of reasonably equivalent value in the context of payments made in furtherance of a Ponzi scheme, Kelly relies on cases from other jurisdictions to demonstrate that, "The rule... is that innocent investors may retain the amount of their initial investment as reasonably equivalent value for the corresponding reduction in their potential restitution claim against the Ponzi scheme operator." Kelly Memorandum, Dkt. No. 86, p. 15.

The first case relied upon by Kelly is *Perkins v. Haines*, 661 F.3d 623 (11th Cir. 2011). There the court summarized prior law to the effect that defrauded investors have a claim for fraud against the debtor arising at the time of the original investment. Any transfer up to the amount of the principal investment satisfies the fraud claim (an antecedent debt) and is made for "value" in the form of the investor's surrender of his or her tort claim. These payments are not recoverable by the

trustee in bankruptcy, but transfers over and above the amount of the principal – representing fictitious profits – are not made for value. The trustee in *Perkins* stipulated that the investor defendants purchased limited partnership interests from the debtor at a time when the Ponzi scheme was already in operation and that a claim for restitution was created in their favor at that time. Therefore, transfers from the debtors up to the amount of the principal investment satisfied the debtor's restitution or fraud claims, and provided value to the debtor.

In *Barclay v. Mackenzie (In re AFI Holding, Inc.)*, 525 F.3d 700 (9th Cir. 2008), the investor defendant invested $73,400 with the debtor as a purported limited partner. When he withdrew from AFI, he received $89,824.18, representing the return of his investment plus $16,424 as a fictitious gain on the investment. The court of appeals emphasized that in the context of state fraudulent transfer law, the "analysis is directed at what the debtor surrendered and what the debtor received *irrespective of what any third party may have gained or lost.*" 525 F.3d at 703, quoting *Wile v. C.H. Rider & Family (In re United Energy Corp.*), 944 F.2d 589, 597 (9th Cir. 1991) (emphasis in the original). Relying on *United Energy* the court of appeals ruled that because the debtor was operating its Ponzi scheme at the time the investor made his initial investment, he acquired a restitution claim at the time that he made his investment. When the debtor returned his investment amount, it was in exchange for the restitution claim. The fictitious gain, however, was in excess of the restitution claim and was avoidable by the trustee in bankruptcy.

In *Jobin v. McKay (In re M & L Business Mach. Co., Inc.*), 84 F.3d 1330 (10th Cir. 1996), the defendant was fraudulently induced to invest in the debtor company without actual knowledge of the fraud. Based upon those facts, the court held that the investor had a colorable claim for the return of his investment, and that payments made to him reduced this restitution claim. The debtor

therefore received reasonably equivalent value and the trustee was not permitted to avoid the transfers. In footnote 6 the court explained that the trustee had also argued that because the investor filed a proof of claim in bankruptcy for the entire amount that he had invested and did not characterize his claim as one for restitution, he did not have a restitution claim. The court agreed with the district court which rejected this argument noting that the investor had a right to restitution whether he claimed it or not, and that he had amended his claim to the amount of the sum of his investments less the payments he had received.

In *Eby v. Ashley*, 1 F.2d 971 (4th Cir. 1924), the court permitted a transferee who received fictitious profits less than the amount of his original investment in good faith to retain the funds, but required that he credit them to the principal debt due to him. With respect to a later payment that exceeded the remaining amount due on the initial investment, the court said that the payment in excess of the principal was without consideration and a fraud on the debtor's creditors.

All of these cases confirm the rule as stated by Kelly which permits the innocent investor to retain transfers received pursuant to a Ponzi scheme up to the amount of his investment. The Trustee has suggested that the rule should not be applied in the present case. I remain concerned, as I said in my prior Proposed Findings and Conclusions, that Kelly's claim (and perhaps others) were included in the restitution sentence at their full face value. The Trustee should carefully review the facts underlying the proof of claim filed by the Department of Justice to ensure that all creditors are treated fairly.

Even though Kelly has demonstrated that value was given for the transfers received by him, he must still demonstrate his good faith in order to prevail on his affirmative defense. As previously stated, the question of good faith should be presented to the jury.

III. CONCLUSIONS

The Trustee has established a prima facie case under 11 U.S.C. § 544(b) and Tennessee Code Annotated § 66-3-605(a)(1). He has shown that Davis made transfers to Kelly during the applicable period in the amount of $46,000 pursuant to a Ponzi scheme and thus with actual intent to defraud creditors. Summary judgment should be **GRANTED** to the Trustee on those issues.

Kelly has shown that he gave reasonably equivalent value for the transfers insofar as his claim for restitution was reduced by the amount of the transfers. Kelly has not conclusively demonstrated, however, that he received the transfers in good faith. On this issue the Trustee has raised issues of fact that should be submitted to the jury. Summary judgment should be **DENIED** Kelly on his affirmative defense.

The Trustee has abandoned alternative theories for avoidance under the Tennessee Code, and summary judgment should be **GRANTED** to Kelly on these issues.

cc: Debtor
Debtor's Attorney
Plaintiff
Plaintiff's Attorney
Defendant
Defendant's Attorney