Docket #0448 Date Filed: 9/15/2014

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS
CENTRAL DIVISION

In re	)	Chapter 11
TELEXFREE, LLC,	)	Case No. 14-40987-MSH
TELEXFREE, INC. and	)	Case No. 14-40988-MSH
TELEXFREE FINANCIAL, INC.,	)	Case No. 14-40989-MSH
Debtors.	)	Jointly Administered

SECURITIES AND EXCHANGE COMMISSION'S OBJECTION TO THE FEE APPLICATION OF GORDON SILVER

The Securities and Exchange Commission ("the Commission") submits this objection to the fee application of Gordon Silver. [Dkt. #381.]

INTRODUCTION

Gordon Silver wants to be paid nearly $230,000, but the vast majority of its fees and expenses were not necessary to the administration of the estate, as is required for a court to approve an application under Bankruptcy Code Section 330(a). Gordon Silver was hired on April 13 and filed TelexFree's Chapter 11 petition late that evening.[1] On April 15 – less than 48 hours later – the FBI seized all of TelexFree's computers and books and records as well as $38 million in cashier's checks, and the Commission filed an enforcement action in the District of Massachusetts charging that TelexFree was an enormous pyramid scheme.[2] The next day, the court in the Commission's case entered a preliminary order freezing all of TelexFree's assets and prohibiting it from raising more money from actual or prospective investors. At that point, TelexFree was effectively out of business, and it was obvious that no reorganization was

[1] Unless otherwise specified, the Commission will refer to the three Debtors collectively as "TelexFree".

[2] The case is *SEC v. TelexFree, Inc. et al*., D.Mass. Case No. 1:14-civ-11858-NMG.

feasible. Nevertheless, Gordon Silver continued to churn the case – racking up nearly $192,000 in fees after April 15. The firm now wants TelexFree's unsecured creditors – virtually all of whom are innocent victims of the pyramid scheme – to foot the bill for its extravagance.

Gordon Silver's requested fees are unjustified in several other respects. First, the firm filed and argued a frivolous motion charging that the asset freeze entered in the Commission's enforcement case violated the automatic stay in Bankruptcy Code Section 362(a). Second, the firm should never have been hired at all. It collaborated in the unjustified decision to file for bankruptcy in Las Vegas, even though the only link to Nevada was a mailing address for TelexFree, LLC, and it wasted substantial attorney time opposing the Commission's inevitable – and successful – motion to transfer venue to Massachusetts. Third, the firm shamelessly overstaffed the case, using four partners and five associates and billing excessive amounts for various projects.

FACTUAL AND PROCEDURAL BACKGROUND

TelexFree was ostensibly in the business of providing "voice over internet protocol" (or "VoIP") service that enabled customers to place phone calls using a computer. In reality, TelexFree was a pyramid scheme that derived almost all its revenue from the sale of "AdCentral" memberships, which promised weekly payments totaling more than 200% per year to investors who placed meaningless internet ads for the VoIP service. AdCentral investors also received bonuses for recruiting new members. Prior to March 9, 2014, AdCentral investors (sometimes referred to as promoters) were not required to sell the VoIP service in order to get paid. [*SEC v. TelexFree*, Dkt. #19 (evidentiary appendix for TRO), #61 (SEC brief for preliminary injunction) at 4-9.]

In 2013, the Brazilian government shut down a TelexFree affiliate for operating an illegal pyramid scheme. [Dkt. #213 (transcript of May 2, 2014 evidentiary hearing) at 118-119.]

On February 13, 2014, TelexFree hired the Boston office of Greenberg Traurig, LLP in connection with an ongoing investigation by the Massachusetts Securities Division ("MSD") that raised concerns about the legality of its compensation plan for promoters. [Dkt. #382-2 (engagement letter).]

On March 9, TelexFree changed its compensation package to require AdCentral promoters to have ten actual VoIP customers in order to be eligible for weekly payments or recruitment bonuses. [Dkt. #213 at 127.] Over the next five weeks, AdCentral promoters asked to withdraw $174 million – an unprecedented amount of requests. [*Id*. at 123.]

On April 7, TelexFree hired Greenberg Traurig concerning a possible bankruptcy filing. [Dkt. #382-3 (amended engagement letter).]

On April 10, TelexFree hired the firm of Alvarez & Marsal to assist with its restructuring plans. [Dkt. #383-1 (engagement letter).]

On April 13, TelexFree hired Gordon Silver as local counsel in Nevada. The firm received a $750,000 retainer.[3] [Dkt. #89-1 (engagement letter).]

At 10:10 p.m. that night (a Sunday), Gordon Silver filed TelexFree's Chapter 11 petitions in Las Vegas. [Dkt. #1.]

Not surprisingly, given the rush to file, the petitions were deficient in many respects. On April 14, the Clerk issued a Notice of Incomplete Filing, citing the lack of a Summary of Schedules, Schedules A-B and D-H, a Statement of Financial Affairs, TelexFree's tax

[3] The Gordon Silver engagement letter is dated April 11, but it was not signed by representatives of TelexFree until April 13. [Dkt. #89-1.]

identification numbers, and a declaration concerning electronic filing. [Dkt. #15.]

On April 14, Gordon Silver filed a standard assortment of "first-day" motions, including motions: (1) for joint administration; (2) for authority to honor credit card transactions; (3) for authority to pay prepetition taxes; (4) to prohibit utilities from suspending service; (5) for authority to reject "certain executory contracts" (actually, all contracts with AdCentral investors); (6) for authority to pay prepetition employee obligations and contractor fees; (7) for approval of notice procedures; (8) for authority to honor prepetition VoIP minutes; and (9) for maintenance of existing bank accounts. [Dkt. ##4-12 & 18.] Judge Landis scheduled a hearing on the "first-day" motions for April 17. [Dkt. #22.]

Also on April 14, the MSD filed an administrative complaint against TelexFree, alleging violations of the state securities laws. [Dkt. #381 at 6, #382 at 7.]

On April 15, the FBI executed search warrants at TelexFree's corporate offices and other locations. Agents seized the company's computer servers, its books and records, and approximately $38 million in cashier's checks. [Dkt. #213 at 62-63, 69, 79-80.]

Also on April 15, the Commission filed an enforcement action in the District of Massachusetts. The action, which was filed under seal, alleged that TelexFree was an illegal pyramid scheme. On April 16, the District Court entered an *ex parte* temporary restraining order ("TRO") that, among other things, froze all of TelexFree's assets and prohibited the company from offering or selling unregistered securities and from soliciting new investors. [*SEC v. TelexFree*, Dkt. #13.] The Court lifted the seal on April 17. [*Id.*, Dkt. #18.]

On April 17, Judge Landis adjourned most of the "first-day" motions until May 2 after being informed about the MSD administrative action, the FBI raid, and the TRO entered in the Commission's case. [Dkt. ##44-52, #382 at 8.]

On April 23, the Commission moved to transfer the cases to Massachusetts. [Dkt. #67.] Gordon Silver filed an opposition to the venue transfer motion on April 29. [Dkt. #120.]

Later on April 23, Gordon Silver filed a motion for an order that portions of the TRO, including the asset freeze, violated the automatic stay under Bankruptcy Code Section 362(a). [Dkt. #70.] The Commission opposed the motion on April 29. [Dkt. #118.]

On April 30 – at the request of Judge Landis – Gordon Silver and the Commission filed briefs on the question of whether, in light of the Commission's enforcement action in District Court, the Bankruptcy Court should abstain from further proceedings. [Dkt. #124, #130.]

On May 2, Judge Landis conducted an evidentiary hearing and heard argument on a number of topics, including the Commission's motion to transfer venue, TelexFree's motion that the TRO violated the automatic stay, and his own request for briefing on abstention. An attorney from Gordon Silver argued those three issues for TelexFree. [Dkt. #213.]

On May 6, Judge Landis held a telephonic hearing at which he delivered his rulings on the pending motions. [Dkt. #197 (audio file).] He granted the Commission's motion to transfer venue to Massachusetts and suspended all other pending matters until after the transfer was complete. [Dkt. ##198-199.]

On May 30, the Court approved the employment of Gordon Silver retroactive to the petition date. [Dkt. ##233.] On July 3, the Court directed the firm to submit any fee applications by August 1. [Dkt. #311.] On August 1, Gordon Silver filed its fee application.[4] [Dkt. #381.] On August 4, the Court scheduled a hearing on fee applications for September 23. [Dkt. #388.]

[4] Greenberg Traurig and Alvarez & Marsal also filed fee applications on August 1. [Dkt. ##382-383.] The Chapter 11 Trustee has reached agreements in principle with both firms concerning those applications. [Dkt. ##446-447.]

ARGUMENT

I. The Applicable Legal Standard

The rules governing a professional's fee application are well-known. Under Bankruptcy Code Section 327(a), a trustee may employ attorneys and other professionals "to represent or assist in carrying out the trustee's duties," subject to court approval. 11 U.S.C. §327(a). Section 328(a) provides that a trustee may employ a professional under Section 327 on "any reasonable terms and conditions of employment." 11 U.S.C. §328(a). Section 1107(a) provides that a debtor-in-possession may perform the duties of a trustee. 11 U.S.C. §1107(a).

Under Section 330(a)(1), a court may award a professional employed under Section 327 "(A) reasonable compensation for actual, necessary services rendered … and (B) reimbursement for actual, necessary expenses." 11 U.S.C. §330(a)(1). Section 330(a)(3) identifies factors for a court to consider when determining what to award, including "(A) the time spent …; (B) the rates charged …; [and] (C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title." 11 U.S.C. §330(a)(3). Under Section 330(a)(4)(A), a court "shall not allow compensation for – (i) unnecessary duplication of services; or (ii) services that were not – (I) reasonably likely to benefit the debtor's estate; or (II) necessary to the administration of the case." 11 U.S.C. §330(a)(4)(A). *See also In re Iannochino*, 242 F.3d 36, 43 (1st Cir. 2001) (quoting §330(a)(4)); *In re 604 Columbus Ave. Realty Trust*, 968 F.2d 1332, 1365 (1st Cir. 1992) (quoting §330(a)(1)).

In assessing the reasonableness of a fee application under Section 330(a), courts have considered, among other things, whether the services were necessary or beneficial, whether the services were adequately documented, whether the professional exercised proper billing

judgment; and whether the fees were reasonable taking into account the statutory factors referenced above. *In re Wolverine, Proctor & Schwartz, LLC*, 2012 WL 3930360, *4-5 (Bankr. D.Mass. Sept. 10, 2012); *In re Invent Resources, Inc*., 2012 WL 5399616, *5 (Bankr. D.Mass. Nov. 5, 2012) (citing *Wolverine*). In other words, courts evaluating fee applications look at: (1) whether the work represents actual compensation rather than overhead; (2) whether the work was necessary; and (3) whether the charge is reasonable. *In re Cumberland Farms*, 154 B.R. 9, 10 (Bankr. D.Mass. 1993). Courts should eliminate time that was unreasonably, unnecessarily, or inefficiently devoted to the case. *In re Lopez*, 405 B.R. 24, 30 (1st Cir. BAP 2009).

The burden of proof for demonstrating the reasonableness of fees is ultimately on the applicant. *In re Sullivan*, 454 B.R. 1, 5 (D.Mass. 2011), *aff'd* 674 F.3d 65 (1st Cir. 2012); *In re LaFrance*, 311 B.R. 1, 20 (Bankr. D.Mass. 2004). *See also In re Narragansett Clothing Co.*, 210 B.R. 493, 498 (1st Cir. BAP 1997), *citing Woods v. City Nat'l Bank & Trust Co. of Chicago*, 312 U.S. 262, 269 (1941).

Here, Gordon Silver intones the standard language about how its services were necessary and beneficial to the estate. [Dkt. #381 at 15-16.] As it has done throughout these proceedings, however, it ignores the grim reality that any reorganization of TelexFree was doomed at the start, because government agencies, including the Commission, had charged TelexFree with operating an illegal pyramid scheme and had taken steps that effectively put TelexFree out of business. The firm also fails to address the unnecessary cost of filing a frivolous motion challenging the TRO as a violation of the automatic stay, the unnecessary cost of filing the case in Nevada, and the substantial amount of overstaffing and duplication of effort.

II. All Time and Expenses Incurred after April 15 Were Unnecessary Because No Reorganization Was Feasible at That Point

Gordon Silver has virtually admitted that the FBI raid on April 15 and the TRO and asset freeze made public on April 17 killed the company. On April 21, it sought a two-month extension for filing TelexFree's initial schedules, asserting that the FBI raid had resulted in an "inability to currently access [its] complete records." [Dkt. #62 at 2.] On April 23, when it filed the motion that the TRO violated the automatic stay, it asserted that the TRO had enjoined TelexFree from operating its VoIP business, paying its employees, or implementing a new business plan, thereby causing "the certain and immediate failure of these Chapter 11 Cases." [Dkt. #70 at 2, 9-10.] On April 30, when it opposed the U.S. Trustee's motion for appointment of a Chapter 11 Trustee, it acknowledged that "[t]he impact of the TRO is effectively to shut down [TelexFree's] underlying business." [Dkt. #128 at 16.] At the hearing on May 2, a representative of Alvarez & Marsal testified that, because of the FBI raid and the asset freeze, TelexFree was unable to accept money, process credit card transactions, pay its employees, or sell its VoIP service. [Dkt. #213 at 80-81.]

In short, as of April 15 – when the FBI seized its computers, its books and records, and $38 million of cashier's checks – and certainly as of April 17 – when the District Court froze all its assets and prohibited it from recruiting new investors – TelexFree was out of business, and there was nothing to reorganize. After all, how could TelexFree possibly hope to develop a viable reorganization plan when it had no access to its computers and its books and records, when all its assets were frozen, and when it was prohibited from soliciting new promoters? At that time, the only prudent way to preserve TelexFree's assets for the benefit of its unsecured creditors, virtually all of whom were innocent investors in AdCentral, was a liquidation.

Instead, Gordon Silver proceeded with the purported reorganization and continued to treat TelexFree as a license to generate substantial fees. The firm has billed nearly $192,000 for work performed after April 15, when the FBI seized TelexFree's computers, books and records, and $38 million of cashier's checks on April 15. It has billed more than $177,000 for work performed after April 17, when the TRO freezing TelexFree's assets and prohibiting the solicitation of new AdCentral promoters became public. [Albers Decl. ¶¶3-5.]

The Court should disallow all fees and expenses incurred after Gordon Silver knew or should have known that the reorganization was doomed. In a case much like this, the Tenth Circuit affirmed the failure to approve fees spent on a reorganization with no chance of success:

> [T]he debtor's inability to successfully develop and complete a plan should have been apparent to counsel from commencement of the case. Therefore, any work performed by [the law firm] was not necessary, and the bankruptcy court did not abuse its discretion in refusing to compensate the law firm for such services.

In re Lederman Enterprises, Inc., 997 F.2d 1321, 1323-24 (10th Cir. 1993). Similarly, the Eighth Circuit has stated, "A court may conclude that an attorney who should have known a reorganization was futile before filing the petition has rendered no service to the estate and should therefore not be compensated for such service." *In Re Coones Ranch*, 7 F.3d 740, 744 (8th Cir. 1993). As another court recently stated, "compensation should be denied when it is clear that the plan was unconfirmable *at the time the plan-related services were rendered*." *In re Quigley Company, Inc.*, 500 B.R. 347, 358-59 (Bkrtcy. S.D.N.Y. 2013) (original emphasis) (citing *Lederman*). *See also In re Vines, Inc.*, 159 B.R. 381 (Bankr. D.Mass. 1993) (no compensation for professionals where it was clear that no reorganization was feasible and counsel's

efforts only worsened the position of creditors).[5]

III. All Time and Expenses Incurred on the Automatic Stay Motion Were Unnecessary Because the Motion Was Frivolous

The Commission and other governmental units use their police and regulatory powers in the public interest. Because of this important public mission, Congress in 1998 approved an explicit governmental unit exception from certain provisions of the automatic stay in Bankruptcy Code Section §362(a). Specifically, Section 362(b)(4) provides that a bankruptcy petition:

> does not operate as a stay … under paragraph (1), (2), (3), or (6) of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit's . . . police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's . . . police or regulatory power.

11 U.S.C. §362(b)(4). In other words, Section 362(a)(3), which prohibits "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate," does not apply when a governmental unit is exercising its police power. As the court in another Commission enforcement case explained:

> In 1998, Congress amended section 362(b)(4) to make clear that governmental police and regulatory actions are excepted from section 362(a)(3) of the Bankruptcy Code, which stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."

[5] *See also In re Universal Factoring Co.*, 329 B.R. 62, 79 (Bankr. W.D.Okla. 2005) (attorneys will not be compensated for time spent in preparation of a plan which has no realistic hope of confirmation"); *In re Crown Oil, Inc.*, 257 B.R. 531, 539 (Bankr. D.Mont. 2000) ("fees may be denied when counsel should have realized that reorganization was not feasible and therefore services in that effort did not benefit the estate"); *In re Office Products of America*, 136 B.R. 983, 990–91 (Bankr. W.D.Tex.1992) ("there was a point in time when the debtor knew or should have known that pursuit of this plan flew in the face of §1129(a), yet the debtor pushed on anyway [but] the services of counsel were no longer 'necessary,' as the debtor was no longer at that point discharging its duties as fiduciary of the estate"); *In re Hunt*, 124 B.R. 263, 267 (Bankr. S.D.Ohio 1990) ("An attorney should not expect to be fully compensated for such unrealistic effort," where feasibility of plan "was nonexistent at the time the plan was offered").

SEC v. Wolfson, 309 B.R. 612, 618 (D.Utah 2004).

As part of its scorched-earth approach to this bankruptcy, Gordon Silver filed a motion that the TRO in the Commission's enforcement case violated the automatic stay under Section 362(a). [Dkt. #70.] In its brief, the law firm relied on case law interpreting the prior version of Section 362(b) – before adoption of the 1998 amendment that explicitly excepted governmental and regulatory actions from Section 362(a)(3). [*See id*. at 15-17, 19-23.] At the May 2 hearing, its attorney argued at length that the TRO constituted the improper "enforcement of a money judgment" against TelexFree. [Dkt. #213 at 283-289, 300.] That argument was nonsense. The TRO was obviously not a money judgment – it was a preliminary equitable order intended to halt the wrongdoing and preserve TelexFree's assets for the benefit of injured investors. *See SEC v. Brennan*, 230 F.3d 65, 72 (2nd Cir. 2000) ("up to the moment when liability is definitively fixed by entry of judgment, the government is acting in its police or regulatory capacity").

A motion based on the superseded version of Section 362(b) and on the fallacious argument that the TRO was a money judgment clearly had no chance of success. Nevertheless, Gordon Silver billed nearly $45,000 for its work on the motion: 115.3 hours by four partners and three associates. [Dkt. #381 at 10-11.] Because the motion was futile and provided no benefit to the estate, the Court should disallow all the fees requested.

IV. Gordon Silver Has Billed for Duplicative and Unnecessary Work Resulting from the Decision to File in Nevada

When the petitions were filed on April 13, TelexFree's offices were in Massachusetts, the two founding officers and sole shareholders and the interim CEO were in Massachusetts, all employees on the payroll were in Massachusetts, the computers and books and records were in Massachusetts, Alvarez & Marsal was planning to do its work in Massachusetts, and the MSD

was investigating TelexFree in Massachusetts. [Dkt. #213 at 100-101, 105, 108; Dkt. #94 at 3.] By contrast, the only connection to Nevada was that one of the three entities (TelexFree, LLC) was incorporated there and had a mailbox there. [Dkt. #213 at 107.]

Gordon Silver's collaboration in the strategic decision to file in Nevada – far from TelexFree's actual operations and from the existing and foreseeable government enforcement activity – led to a duplication of effort with Greenberg Traurig. For example, the two firms billed virtually identical amounts (approximately $45,000 each) for work on the frivolous automatic stay motion discussed above. [Dkt. #381 at 10-11, Dkt. #381-4 at 12-15, Dkt. #382 at 12, Dkt. #382-1 at 16.]

In addition, given TelexFree's strong presence in Massachusetts and lack of contacts with Nevada, it was inevitable that someone – the Commission, as it turned out – filed a motion to transfer venue to Massachusetts. Nor is it surprising that the transfer motion was successful. The amount billed for opposing the motion is difficult to determine, because Gordon Silver included it within a more general "Litigation" category. A review of the firm's billing detail suggests that three partners, two associates, and one paralegal worked nearly fifty hours on the opposition, for which it has billed approximately $20,000. [Dkt. #381-4 at 21-26.]

V. Gordon Silver Overstaffed the Case

A mere glance at the list of Gordon Silver personnel who worked on the TelexFree case – four partners and five associates – reveals the degree of overstaffing. [Dkt. #381-2.] It is not feasible to identify every single example of excessive billing for specific projects, but a few examples will underscore the level of billing overkill:

1. Gordon Silver billed $33,342 for 89.6 hours by three partners, three associates,

and two paralegals on the petitions, the schedules (although virtually all the required schedules were not actually filed), and the formulaic first-day motions. [Dkt. #381 at 10, Dkt. #381-3 at 5.]

2. One partner and two associates spent more than eleven hours on a motion to strike the Commission's supplemental filing on the automatic stay issue, even though the filing had merely referenced one additional case. [Dkt. #167, Dkt. #193, Dkt. #381-4 at 14-15.]

3. An associate spent 3.4 hours opposing the Commission's request for an abbreviated hearing schedule. [Dkt. #381-4 at 21.]

Even if the Court determines to award compensation to Gordon Silver for work performed after April 15 (or April 17), it should make a substantial reduction in the amount in light of Gordon Silver's overstaffing and overbilling. *See* 11 U.S.C. §330(4)(A)(i) (no compensation for unnecessary duplication of services); *In re LaFrance*, 311 B.R. 1, 20 (Bankr. D.Mass. 2004) (no compensation for "duplicative, unproductive [or] excessive" fees); *In re Pettibone Corp.*, 74 B.R. 293, 303 (Bankr. N.D.Ill. 1987) (duplication of services should be disallowed as unnecessary).

CONCLUSION

The Court should disallow compensation for all of Gordon Silver's work performed after the FBI raid on April 15 (or after the TRO became public on April 17). Alternatively, the Court should: (1) disallow compensation for all work on the automatic stay motion; (2) disallow compensation for duplicative work and work spent opposing the venue transfer motion; and (3) substantially reduce the amount awarded in light of Gordon Silver's overstaffing and overbilling.

Respectfully submitted,

/s/ Frank C. Huntington
Frank C. Huntington (BBO #544045)
huntingtonf@sec.gov
Deena R. Bernstein (BBO 558721)
bernsteind@sec.gov
SECURITIES AND EXCHANGE COMMISSION
Boston Regional Office
33 Arch St., 23rd Floor
Boston, MA 02110
(617) 573-8960 (Huntington direct)
(617) 573-8813 (Bernstein direct)
(617) 573-4590 (fax)

Dated: September 15, 2014

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Debtors.	)	Jointly Administered

DECLARATON OF MARK ALBERS

Mark Albers, pursuant to 28 U.S.C. §1746, hereby declares as follows:

1. I am a Forensic Accountant in the Boston Regional Office of the Securities and Exchange Commission ("the Commission"). My duties include conducting investigations relating to potential violations of the federal securities laws, and performing statistical analysis of information provided to the Commission by third parties.

2. I make this declaration based upon my personal knowledge as set forth below and in support of the Commission's objection to the fee applications submitted by Gordon Silver (Dkt. #381).

3. Members of the Commission staff working under my supervision entered all the billing detail from the fee applications into a master Excel spreadsheet. This made it possible for us to sort and tabulate the information in various ways.

4. By sorting the data chronologically, we determined that Gordon Silver incurred $191,926 of fees after April 15.

5. We also determined that Gordon Silver incurred $177,144 of fees after April 17.

Executed this 15th day of September 2014.

/s/ Mark Albers
Mark Albers
Forensic Accountant
Securities and Exchange Commission
Boston Regional Office
33 Arch Street, 23rd Floor
Boston, MA 02110

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CERTIFICATE OF SERVICE

I, Frank C. Huntington, hereby certify that on September 15, 2014, I caused a copy of the *Securities and Exchange Commission's Objection to the Fee Application of Gordon Silver* to be served via operation of this Court's CM/ECF System on the parties listed on the attached service list.

/s/ Frank C. Huntington
Frank C. Huntington (BBO #544045)
huntingtonf@sec.gov
SECURITIES AND EXCHANGE COMMISSION
Boston Regional Office
33 Arch St., 23rd Floor
Boston, MA 02110
(617) 573-8960 (Huntington direct)
(617) 573-4590 (fax)

BY ECF:

Charles R. Bennett cbennett@murphyking.com, bankruptcy@murphyking.com; imccormack@murphyking.com

Kendra Berardi kberardi@rc.com, mjewell@rc.com

Deena R. Bernstein bernsteind@sec.gov, #brodocket@sec.gov

Roger Bertling rogerbertling@yahoo.com, rbertlin@law.harvard.edu

Robert J. Bonsignore rbonsignore@class-actions.us, jlent@class-actions.us

C. Elizabeth Brady Murillo emurillo@burnslev.com

Alan L. Braunstein abraunstein@riemerlaw.com, ahall@riemerlaw.com

Douglas Brooks dbrooks@libbyhoopes.com

Orestes G. Brown obrown@metaxasbrown.com

John Commisso john.commisso@jacksonlewis.com

Christopher M. Condon cmc@murphyking.com

Edward Dangel tdangel@dangeldwyer-llc.com

Ronald A. Dardeno rdardeno@dardeno.com

Joseph P. Davis davisjo@gtlaw.com, ponsettoj@gtlaw.com

Christine E. Devine cdevine@mirickoconnell.com, bankrupt@mirickoconnell.com

Adam K. Doerr adoerr@rbh.com

Martin B. Dropkin nmatza@hotmail.com; nastor@dropkinmatza.com; mdropkin@dropkinmatza.com

Daniel Dullea scott@goldberganddullea.com

Kate P. Foley kfoley@mirickoconnell.com

Robert W. Fuller rfuller@rbh.com

Andrew J. Gallo andrew.gallo@bingham.com

Stuart M. Glass sglass@choate.com

William J. Hanlon whanlon@seyfarth.com, bosdocket@seyfarth.com

Carol E Head carol.head@bingham.com

Lawrence P. Heffernan lheffernan@rc.com, kberardi@rc.com

Nellie E Hestin nhestin@reedsmith.com; lsizemore@reedsmith.com; jdoolittle@reedsmith.com; mkrizan@reedsmith.com

Jonathan Horne jhorne@jagersmith.com, bankruptcy@jagersmith.com

Paul V. Kelly paul.kelly@jacksonlewis.com

Richard T. King richard.t.king@usdoj.gov

Andrew G. Lizotte agl@murphyking.com, bankruptcy@murphyking.com; pas@murphyking.com; ddk@murphyking.com; agl@murp hyking.com

Danielle Andrews Long dlong@rc.com, jsantiago@rc.com

S. Elaine McChesney Elaine.mcchesney@bingham.com

Harold B. Murphy bankruptcy@murphyking.com, ddk@murphyking.com

Michael K. O'Neil moneil@murphyking.com, imccormack@murphyking.com

Carmenelisa Perez-Kudzma attorney.carmenelisa@gmail.com, evan.slater@gmail.com

Lee M. Pollack lmpollack@jonesday.com

Ian D. Roffman iroffman@nutter.com, epleadings@nutter.com; cfeldman@nutter.com; kcannizzaro@nutter.com

Mark C. Rossi Esher.RossiECF@gmail.com, Esher.RossiECF2@gmail.com

Paul S. Samson psamson@riemerlaw.com

Kenneth I. Schacter kenneth.schacter@bingham.com

Ari M. Selman ari.selman@bingham.com

Jordan L. Shapiro JSLAWMA@aol.com

Monica Snyder msnyder@murthalaw.com, kbratko@murthalaw.com

Joseph Toomey jtoomey@nutter.com

Thomas S. Vangel tvangel@murthalaw.com

Sarah W. Walsh sarah.walsh@jacksonlewis.com

Jason C. Weida jweida@jonesday.com