Docket #0041 Date Filed: 8/5/2016

**UNITED STATES BANKRUPTCY COURT**
**DISTRICT OF MASSACHUSETTS**
**CENTRAL DIVISION**

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| In re: | ) | Chapter 11 |
| | ) | |
| | ) | Case No. 14-40987 |
| TELEXFREE LLC., et al.,[1] | ) | |
| | ) | Jointly Administered |
| Debtors. | ) | |
| | ) | |
| | ) | |
| STEPHEN B. DARR AS TRUSTEE OF THE ESTATES OF TELEXFREE, LLC, TELEXFREE, INC. and TELEXFREE FINANCIAL, INC., | ) | |
| | ) | Adversary Proceeding No. 15-04055 |
| Plaintiffs, | ) | |
| | ) | |
| v. | ) | |
| | ) | |
| RITA DOS SANTOS, INDIVIDUALLY AND AS PUTATIVE CLASS REPRESENTATIVE, AND MARIA MURDOCH, ANGELA BATISTA JIMINEZ, ELISANGELA OLIVEIRA AND DIOGO DE ARAUGO, AS PUTATIVE CLASS REPRESENTATIVES, | ) | |
| | ) | |
| Defendants. | ) | |

**MEMORANDUM IN SUPPORT OF PIEC'S MOTION FOR SUMMARY JUDGMENT**

**INTRODUCTION**

By this Adversary Proceeding, the Chapter 11 Trustee, Stephen Darr, improperly attempts to arrogate to himself the right to bring the direct claims of individual creditors for their own particularized harms suffered at the hands of the non-debtor "Promoter-Participants." The Trustee's gambit violates long-standing United States Supreme Court precedent which makes

[1] The debtors (the "Debtors") in these cases (collectively, the "Chapter 11 Cases") are TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc.

clear the Trustee's lack of standing to prosecute such claims. Recognizing that prohibition, the Trustee instead encourages this Court to make new law by asserting that the payment of dollars by individual "Victim-Participants" to non-debtor Promoter-Participants was sufficiently entwined with the hybrid Ponzi/pyramid scheme operated by the Debtors that such payments should be considered "property of the debtors' estate" and the individual Victims' claims nothing more than "disguised fraudulent transfer claims" that the Trustee has the exclusive right to prosecute. Notwithstanding the intellectual gymnastics this novel approach requires, the Trustee cannot escape the undisputed facts that negate the proposition that the Victims' payments were ever property of the Debtors' estate. In particular:

- the Debtors never possessed any of the monies paid by a Victim-Participant to a Promoter-Participant;
- the Debtors never commingled such monies with TelexFree's other assets so as to render them traceable;
- the Debtors never themselves made a transfer of the commingled monies to the Promoter-Participants;
- the Debtors experienced no diminishment of their estate in connection with the payment of these monies;
- the Debtors had no legal right to the monies so transferred; and
- the Victims suffered a particularized injury for which the Trustee is not authorized to recover.

The Trustee's claims fail for any one of these reasons, each of which is individually and independently sufficient to defeat the Trustee's standing to recover payments made by Victim-Participants to Promoter-Participants. Try as he might, the Trustee further cannot ignore that the Debtors ran a Ponzi scheme that relied, in part, on the actions of various non-debtor third parties such as banks, payment processors, attorneys, accountants, and the Promoter-Participants. Those

third parties committed independent torts against the Victim-Participants and, as a result, the Victims' direct claims against these third parties are theirs and theirs alone to bring.

As there are no material facts in dispute, summary judgment dismissing the Trustee's complaint in its entirety is appropriate.

## VICTIMS' CLAIMS[2]

The Plaintiffs' Interim Executive Committee (the "PIEC") is the authorized representative of Victims of the TelexFree Ponzi and pyramid scheme, charged with prosecuting litigation on their behalf. See SUF ¶ 1, Exhibit A at 1-2. The PIEC has filed actions in the United States District Court for the District of Massachusetts to recover "Participant-to-Participant Payments" for the benefit of TelexFree's Victims, including complaints consolidated within the MDL Proceedings and an additional action filed on February 24, 2016 in the District Court for this District for consolidation into the MDL Proceedings. See SUF ¶¶ 2-8, Exhibits B-K.

In actions filed in June 2014, Victims of TelexFree brought several actions against the master-minds behind TelexFree and certain other major non-debtor promoters and co-conspirators. See SUF ¶ 2, Exhibits B-E. By order dated October 22, 2014, the District Court transferred these actions to the MDL Proceedings. See SUF ¶ 3, Exhibit F. The PIEC consolidated the complaints filed in the prior actions in the *Second Consolidated Amended Complaint*, filed on April 30, 2015 (the "SCAC"). See SUF ¶ 4, Exhibit G. In the SCAC, the PIEC named over forty (40) defendants, including James Merrill and Carlos Wanzeler, the

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2 All citations in this section refer to the *Local Bankruptcy Rule 7056-1 Statement of Undisputed Material Facts in Support of PIEC's Motion for Summary Judgment* ("SUF"), filed contemporaneously herewith. Exhibits A-M attached to the SUF are pleadings filed in various court actions, as to which the Court may take judicial notice. See Martin v. Mead Johnson Nutrition Co., Civil Action No. 09-11609-NMG, 2010 WL 3928710, at *1-2 (D. Mass. Sept. 13, 2010). Capitalized terms used but not otherwise defined herein shall have the meanings ascribed to them in the SUF.

master-minds behind TelexFree, and certain major non-debtor promoters and co-conspirators for fraud, securities fraud, and a variety of other torts. See SUF ¶ 4, Exhibit G at ¶¶ 39-100, 1004-1098. The suit also named various banks, payment processors, attorneys, and accountants for aiding and abetting these torts. See id. The PIEC brought unjust enrichment claims against all defendants, including specifically several Promoter-Participants, in the SCAC.[3] See SUF ¶ 4, Exhibit G at ¶¶ 1037-1043.

In an additional action filed on February 24, 2016, styled *Murdoch et al. v. TelexElectric, LLLP et al.*, the PIEC commenced a civil action in the United States District Court for the District of Massachusetts asserting claims against forty-seven Promoter-Participants, including a claim for unjust enrichment (the "Oliveira Action" and together with the SCAC, the "Unjust Enrichment Claims").[4] See SUF ¶ 7, Exhibit J.

On October 7, 2015, the Trustee initiated this Adversary Proceeding seeking a declaratory judgment that the PIEC's Unjust Enrichment Claims in both suits violated the automatic stay and an injunction prohibiting further prosecution of the Unjust Enrichment Claims insofar as they name the Promoter-Participants as defendants.[5] See SUF ¶ 9, Exhibit L at ¶¶ 39-48. The Trustee's proceeding is predicated on his allegation that all dollars paid by a Victim-Participant directly to a Promoter-Participant constitute a fraudulent transfer of TelexFree property which the Trustee has the exclusive authority to recover. See SUF ¶ 10, Exhibit M at ¶¶ 33-43.

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3 On September 23, 2015, the PIEC commenced an action in the United States District Court for the District of Arizona against the same defendants named in the SCAC (the "Arizona Action"). See SUF ¶ 5, Exhibit H. On October 21, 2015, the Arizona Action was transferred to the United States District Court for the District of Massachusetts. See SUF ¶ 6, Exhibit I at 1. The Arizona Action Complaint largely parallels the SCAC, except that it was expanded to include a request for certification of a class of Defendants who are "Net Winners" and received payments from other Participants. See SUF ¶ 5, Exhibit H at ¶¶ 1012-1021.

4 The Oliveira Action was amended on June 27, 2016 to remove Maria Murdoch, Angela Batista Jiminez, and Diogo de Araugo as named plaintiffs. See SUF ¶ 8, Exhibit K.

5 The Trustee filed an amended complaint on February 26, 2016. See SUF ¶ 9, Exhibit M.

## FACTS[6]

TelexFree operated a hybrid Ponzi and pyramid scheme that ostensibly revolved around the sale of membership plans and monthly voice over internet phone ("VoIP") packages. See SUF ¶ 11, Exhibit M at ¶¶ 11, 14. A person could become a participant ("Participant") in the TelexFree scheme by purchasing either a membership plan or VoIP package. See SUF ¶ 12, Exhibit M at ¶¶ 9, 14.

Each time a Participant purchased a membership plan or VoIP package, the Debtors established a user account ("User Account") to track the activity of that Participant. See SUF ¶ 12, Exhibit M at ¶ 14. Purchase of a membership plans could occur in two discrete ways. See SUF ¶ 14, Exhibit M at ¶ 15. One way was for a new Participant to purchase his or her membership plan directly from TelexFree. See id. In this transaction, the new Participant paid the membership fee directly to TelexFree. See SUF ¶ 15, Exhibit M at ¶ 16. TelexFree received the money and opened a User Account that would then track the Participant's subsequent activity. See id.

Alternatively, a new Participant (a "Victim-Participant" or "Victim") could purchase a TelexFree membership plan directly from an existing Participant (a "Promoter-Participant"). See SUF ¶ 16, Exhibit M at ¶¶ 17-18. In this latter transaction, the Victim-Participant would pay the membership fee directly to the Promoter-Participant (hereinafter, a "Participant-to-Participant Payment") and TelexFree would establish a User Account for the Victim-Participant. See SUF ¶ 16, Exhibit M at ¶ 18. TelexFree would issue the Victim-Participant an invoice for the membership fee, the Promoter-Participant would satisfy the invoice with credits previously

6 All citations in this section refer to the SUF. As stated above, Exhibits A-M attached to the SUF are pleadings filed in various court actions, as to which the Court may take judicial notice. Exhibits N-O attached to the SUF are part of the evidentiary record with respect to papers filed and evidence admitted in the main bankruptcy cases of TelexFree, LLC, TelexFree, Inc. and TelexFree Financial, Inc., Case Nos. 14-40987 through 14-40989, which the parties have agreed that the Court may consider.

accumulated by the Promoter-Participant, and the Victim-Participant paid the invoice amount directly to the Promoter-Participant. See id. This alternative transaction is now characterized by the Trustee as a "Triangular Transaction." See SUF ¶ 16, Exhibit M at ¶ 17. In this alternative transaction, the Debtors never received or had possession of the membership fees paid by the Victim-Participant to the Promoter-Participant. See SUF ¶ 16, Exhibit M at ¶ 17-18.

To evaluate the merits of the Trustee's assertions and the propriety of the relief requested, it is critical to understand the novel scheme created by the Debtors. As stated above, the TelexFree scheme exhibited features of both a Ponzi scheme and a pyramid scheme. See SUF ¶ 13, Exhibit M at ¶ 11. Its Ponzi scheme features were the promise of significant returns on investment simply for paying money over to TelexFree (or a Promoter-Participant) and the generation of credits by posting internet ads for a VoIP product that was more mirage than real.[7] See id. The pyramid feature of the scheme is found in the Participant-to-Participant relationship, where an existing Participant could recruit new Participants and receive payments directly from those Participants. See id. The Participant-to-Participant Payments were facilitated by the redemption of accumulated "credits" by the Promoter-Participant in TelexFree. See SUF ¶ 16, Exhibit M at ¶ 18. But the credits previously issued by TelexFree to the Promoter-Participant were simply one aspect of an illegal scheme and had no actual value or utility outside of perpetrating the fraud upon the next unwitting Victim. See SUF ¶ 18, Exhibit N at 54:14-16, Exhibit O at ¶ 35.

What truly makes the TelexFree scheme unique is that only some of the dollars extracted from Victims were paid to and came into the possession of TelexFree. See SUF ¶ 14-16, Exhibit M at ¶¶ 14-18. Most of the monies extracted from the Victims were extracted by other

[7] TelexFree's revenues from the sales of VoIP packages were inconsequential compared to its overall operations and the vast majority of TelexFree's revenue came from the purchase of membership plans by Participants. See SUF ¶ 19, Exhibit O at ¶ 35.

individual, non-debtor, non-insider Participants. See SUF ¶ 19, Exhibit O at ¶ 35. While TelexFree issued invoices associated with the sale of both membership plans and VoIP packages and purported to show a face value of $3,073,461,326, only $359,792,242, or approximately twelve percent (11.7%) of that amount, was paid in cash to the Debtors by Victims. See SUF ¶ 19, Exhibit O at ¶ 35. The near 90% balance of these invoices, totaling over $2,713,679,084, were actually Participant-to-Participant cash transactions, with the fictitious invoices and associated credits constituting the only aspects involving the Debtors. See id.

The Unjust Enrichment Claims brought by the Victim-Participants are brought only against Promoter-Participants who received those Participant-to-Participant Payments. See SUF ¶ 20, Exhibit G at ¶¶ 51-62, Exhibit H at ¶¶ 1012-1021, Exhibit K at ¶¶ 18-72. The Victim-Participants themselves can be broken down into two categories: (1) new Participants who made one or more Participant-to-Participant Payments and did not thereafter recruit additional Participants; and (2) new Participants who made one or more Participant-to-Participant Payments and did thereafter recruit some new Participants but nonetheless ended up on a net basis suffering damage (that is a Victim-Participant who originally paid in $X and received $X-Y, with Y being less than X). See SUF ¶ 17, Exhibit M at ¶¶ 14-18. As will be shown below, the distinction between these two groups of plaintiffs is not legally relevant. In both scenarios, no monies were ever paid to or possessed by the Debtors, and hence not commingled with the Debtors' other assets or subject to any later potential transfer to third parties. See SUF ¶ 16, Exhibit M at ¶¶ 14-18. In fact, none of the Participant-to-Participant Payments involved a transfer of money from the Debtors to any Promoter-Participant. See id.

## ARGUMENT

The Trustee concedes, as he must, that he lacks standing to sue, on behalf of Victim-Participants in their capacity as TelexFree's creditors, the non-debtor Promoter-Participants to

recover the Participant-to-Participant Payments. See Caplin v. Marine Midland Grace Tr. Co. of N.Y., 406 U.S. 416, 428 (1972) (trustee under Chapter X of the Bankruptcy Act did not have standing to sue indenture trustee on behalf of holders of debentures issued by debtor); In re Ozark Rest. Equip. Co., 816 F.2d 1222 (8th Cir. 1987) (Congress, in enacting the Bankruptcy Code in 1978, chose not to overrule Caplin); see also E.F. Hutton & Co. v. Hadley, 901 F.2d 979 (11th Cir. 1990); Williams v. California 1st Bank, 859 F.2d 664 (9th Cir. 1988) (trustee lacked authority to sue on behalf of debtor's creditors). Instead, the Trustee asserts that he is not attempting to usurp those direct and personal claims; rather he is simply attempting to prevent the Victim-Participants from maintaining "disguised fraudulent transfer" claims. It is the Trustee, however, in this Adversary Proceeding, who seeks to disguise, as fraudulent transfer claims, what are clear direct and personal claims of the Victim-Participants.

Granting the relief requested in the Adversary Proceeding would allow the Trustee to recover monies that the Debtors never themselves possessed, controlled, or transferred to any third party, and to which they never had any legally valid claim. See SUF ¶ 16, Exhibit M at ¶¶ 14-18. This would create an entirely new common-law based theory of fraudulent conveyance law, as neither the Bankruptcy Code nor applicable case law grants the Trustee such broad authority. It would also fly in the face of prior Supreme Court teachings. See Caplin, 406 U.S. at 434 ("Congress has not yet indicated even a scintilla of an intention" to confer on bankruptcy trustee standing to sue third parties); see also Ozark, 816 F.2d at 1228 ("[W]e believe Congress' message is clear – *no* trustee . . . has power under Section 544 of the Code to assert general causes of action [] on behalf of the bankrupt estate's creditors."). The claims to recover the Participant-to-Participant Payments instead belong to the individual Victims who suffered injury at the hands of the Promoter-Participants.

## I. The Summary Judgment Standard

Summary judgment is appropriate when the moving party 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). A fact is material only if it may affect the outcome of the litigation. See Volkswagenwerk Aktiengesellschaft v. Wheeler, 814 F.2d 812, 815 (1st Cir. 1987); Williams v. City of Brockton, 146 F. Supp. 3d 290, 301 (D. Mass. 2015). "'[A]n issue is genuine if it may reasonably be resolved in favor of either party." Vineberg v. Bissonette, 548 F.3d 50, 56 (1st Cir. 2008) (quotations and citations omitted).

"Essentially, Rule 56[ ] mandates the entry of summary judgment 'against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial.'" Coll v. PB Diagnostic Sys., 50 F.3d 1115, 1121 (1st Cir. 1995) (quoting Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986)). As set forth below, there are no material facts in dispute: the Trustee concedes, indeed champions the fact, that TelexFree was a Ponzi scheme designed to defraud; the structure of the scheme could, and more often than not did, result in non-debtor Promoter-Participants engaging in direct and fraudulent transactions with Victims through which these Victims paid the Promoter-Participants directly the monies which the PIEC now seeks to recover. The Trustee acknowledges that the Debtors never came into possession of the monies at issue. From these undisputed facts flows the legal conclusions that the Victims own direct claims covering particularized harm that do not involve property of the Debtors' estates. Summary judgment in favor of the PIEC, dismissing the Adversary Proceeding, is thus compelled.

## I. The Participant-to-Participant Payments Do Not Constitute Property Of The Estate And Are Not Recoverable By The Trustee

In his effort to manufacture standing, the Trustee argues that the Participant-to-Participant Payments were in effect transfers of property of the Debtors' estate and he, and only he, has the authority to sue to recover these monies from the Promoter-Participants. In reality, the circumstances surrounding the TelexFree scheme demonstrate that the funds transferred by Victims to Promoter-Participants – that is, the Participant-to-Participant Payments at issue here – were never property of the estate. The right to recover the Participant-to-Participant Payments indisputably belongs to the individual Victim-Participants, regardless of whether such Victim later recruited additional Participants, because such payments were never delivered to or in the possession of the Debtors, were never held in any accounts controlled by the Debtors or commingled in a common account, and the Debtors never transferred those monies to third parties. See SUF ¶ 16, Exhibit M at ¶¶ 17-18. Even more, the Debtors had no *legal right* to possess or control these funds.

### *A. The Participant-to-Participant Payments Were Never In The Possession of the Debtors*

This Court has already ruled that TelexFree operated as a Ponzi scheme. See *Amended Order on Motion by Chapter 11 Trustee for Entry of Order Finding That Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief*, Case No. 14-40987 [Docket No. 668]. Ponzi schemes often end in bankruptcy when the scheme inevitably collapses. There is thus a long list of bankruptcy cases in which a trustee has successfully prosecuted fraudulent transfer claims on behalf of the estate for transfers made by the debtor/fraudster to non-debtor third parties. See, e.g., Floyd v. Dunson (In re Ramirez Rodriguez), 290 B.R. 424 (Bankr. S.D. Tex. 1997); Sender v. Buchanan (In re Hedger-Invs. Assocs., Inc.), 163 B.R. 841 (Bankr. D. Colo. 1994), aff'd 84 F.3d 1286 (10th Cir. 1996); Dicello v. Jenkins (In re Int'l Loan Network, Inc.), 160 B.R. 1

(Bankr. D.D.C. 1993); In re Taubman, 160 B.R. 964 (Bankr. S.D. Ohio 1993); Merrill v. Dietz (In re Universal Clearing House Co.), 62 B.R. 118 (D. Utah 1986). In every such case, however, the debtor had "title" to the property transferred.

In the context of a Ponzi scheme, it is axiomatic that the property acquired by the debtor from the victim bestows upon the debtor voidable title only. See In re Universal Clearing House Co., 62 B.R. at 123 ("An agreement induced by fraud [] is merely voidable, not void."). But such voidable title only arises from the fact that the fraudster had actual possession of the property later transferred. See id. at 124 ("[A]lthough it may be true that one who steals or embezzles money obtains no title to it, one who obtains money by fraud obtains some interest, namely, a defeasible title."). That is why, in *every* bankruptcy case involving a Ponzi scheme in which a trustee successfully brings a fraudulent transfer action, the assets transferred by the debtor were in the debtor's actual possession prior to the transfer. See In re Ramirez Rodriguez, 209 B.R. at 429 (purchase price for contracts *paid directly by investors to the debtors*, deposited in accounts held or controlled by the debtors, and commingled with other investors' funds); In re Universal Clearing House Co., 62 B.R. at 123 (payments made pursuant to "investor contracts" *paid directly by the investor to the debtors* and commingled in a common fund controlled by the debtors); In re Hedged-In. vs. Assoc., Inc., 163 B.R. at 850 (Ponzi scheme "*debtor came into possession* of all of these funds by the voluntary payment of the investors" (emphasis added)); In re Int'l Loan Network, Inc., 160 B.R. at 7-8 (investors purchased memberships by *transferring funds directly to the debtor* at their corporate headquarters, which funds the debtor commingled with its other money); In re Taubman, 160 B.R. at 972, 978 *(investors transferred funds directly to the debtors*, which funds were held in bank accounts controlled by the debtor and commingled with the funds of other investors); Raforth v. First Nat'l Bank of Barnesville (In re Baker &

Getty Fin. Servs. Inc.), 98 B.R. 300, 306 (Bankr. N.D. Ohio 1989) (*investors transferred funds directly to the debtors* and the debtor held and commingled funds in common accounts); Geltzer v. Barish (In re Geltzer), 502 B.R. 760, 764, 768 (Bankr. S.D.N.Y. 2013) (*investors transferred money directly to the debtor* and all investor funds were held in commingled accounts controlled by the debtor).

As this long list of cases demonstrates, the critical element leading to a finding that the property later transferred by the debtor was property of the estate was *possession*. Without possession, a fraudster can make no claim to title, even voidable title, over transferred assets. Here, the Trustee concedes that the Debtors never had possession of any of the monies transferred between non-debtor Victim-Participants and non-debtor Promoter-Participants. See SUF ¶ 16, Exhibit M at ¶ 18. As such, they never held title to such monies. That alone is the beginning and the end of the analysis and compels dismissal of the Trustee's complaint with prejudice.

But there are other reasons as well. These very same cases make clear that what substantiates a fraudulent transfer case in a Ponzi scheme situation is both possession *and commingling* of funds. The commingling is likewise critical because commingling eliminates the ability to trace the funds that are thereafter transferred and to maintain a direct action. See, e.g., In re Baker & Getty Fin. Servs. Inc., 98 B.R. at 306 (where a debtor obtains money by fraud and mingles it with other money so as to preclude any tracing the money is property of the debtor under sections 547 and 548 of the Bankruptcy Code); In re Universal Clearing House, 62 B.R. at 124 ("[W]here a debtor obtains money by fraud and mingles it with other money so as to preclude any tracing and where the defrauded party does not timely avoid the transaction, the money is 'property' of the debtor within the meaning of section 548 of the Code.") Of course,

since the Debtors here never had possession of the Participant-to-Participant Payments, the Debtors could not and did not commingle those payments with the monies fraudulently obtained from other Victims who paid the Debtors directly for membership plans.[8] See SUF ¶ 16, Exhibit M at ¶¶ 14-18.

The Trustee has not cited a single Ponzi scheme/fraudulent transfer case that grants a trustee standing to recover monies that were never in the possession of the debtors, never commingled with the debtors' other assets, and never transferred by the debtor to a third party, from those commingled assets. Instead, the Trustee urges the Court to create entirely new law, asking for a finding that the payments made by Victims to Promoter-Participants should be treated *as if* they were transfers made by the Debtors to those Promoter-Participants because the transactions were aided and abetted by the Debtors. The dozens of trustees for the dozens of estates for the dozens of prior Ponzi and pyramid schemes did not seek or obtain such novel relief, and for good reason: the Trustee's request for a radical expansion of standing here lacks the key element present in all of the cited cases in which relief WAS granted, possession. The Trustee cannot overcome the fact that the Debtors at no time received, possessed, controlled or transferred the monies constituting the Participant-to-Participant Payments. The Debtors thus never held title to those monies, and the Trustee cannot claim that these funds were at any point property of the Debtors' estate.

Based on the foregoing, the Trustee cannot establish that the Participant-to-Participant Payments are transfers of property of the Debtors' estate and therefore has no right to pursue

[8] In the absence of possession and commingling, there could not be and was no actual transfer of funds by the Debtors to any Promoter-Participant third party. See SUF ¶ 16, Exhibit M at ¶¶ 14-18. Again, without possession of the money, commingling or not, there was nothing for the Debtors to transfer; and indeed there were no transfers by the Debtors.

causes of action to recover the Participant-to-Participant Payments on behalf of the Debtors' estate.

*B. The Debtors Never Had Any Legal Right To The Participant-to-Participant Payments*

In an effort to overcome the fatal lack of possession over the Participant-to-Participant Payments, the Trustee next attempts to cast the Participant-to-Participant Payments as property of the estate by asserting that they were obligations owed by the Victims to the Debtors, which obligations were satisfied by the Promoter-Participants' surrender of previously accrued credits simultaneously with the actual payment of money by the Victim to the Promoter. This co-dependency, as it were, the Trustee labels a "Triangular Transaction," which he then analogizes to leveraged buyouts and other collapsible transactions. This tortured logic does not hold up on these facts.

First, it is incontrovertible that the Trustee cannot succeed to any greater rights in property than pre-bankruptcy TelexFree had. See Sender v. Buchanan (In re Hedged-Invs. Assocs., Inc.), 84 F.3d 1281, 1284-85 (10th Cir. 1996) (concluding that no exception in the Bankruptcy Code allowed chapter 7 trustee to take "greater rights than the debtor himself had" in a Ponzi scheme). The Trustee must have a *legal right* to the funds transferred as Participant-to-Participant Payments in order to recover those funds on behalf of the Debtors' estate. But because TelexFree was itself a criminal enterprise, it had no legal right to the cash transferred by Victims as Participant-to-Participant Payments to third party Promoters. See, e.g., Manta Mgmt. Corp. v. City of San Bernadino, 44 Cal. Rptr.3d. 35, 48 (Cal. Ct. App. 2006) (stating that company "is not entitled to recover any portion of its profits that were generated by illegal activity"), rev'd on other grounds, 181 P.3d 159 (Cal. 2008). Moreover, as detailed above, where fraud is involved, the fraudster only acquires any sort of title—in this case voidable title—

once the fraudster takes physical possession of the property. Since the Debtors never had possession of the Victim-Participant's monies, and those Participant-to-Participant Payments were the product of an illegal scheme, the Debtors had no form of title and no right to demand any.

Second, the fact that the Promoter-Participant's fraud upon the Victim-Participant was facilitated by the utilization of the fictitious credits minted indiscriminately by TelexFree and then fraudulently "issued" to the Promoter-Participant, and the phony "invoice" issued by TelexFree to the Victim, neither created a legal debt owed to TelexFree that was satisfied nor involved property of the estate (i.e., credits) utilized by the Victim-Participant to "satisfy" that fictitious debt. The invoices issued by TelexFree to the Victim-Participants were merely an element of the fraudulent Ponzi/pyramid scheme. See SUF ¶¶ 11-12, 16, 19, Exhibit M at ¶¶ 14, Exhibit O at ¶ 35. The invoice was thus illegal, illegitimate and wrongful, and did not create in favor of TelexFree a legally enforceable claim against the Victim-Participant. See Manta Mgmt. Corp., 44 Cal. Rptr. 3d. at 48 (stating that company "is not entitled to recover any portion of its profits that were generated by illegal activity"); Wilson v. HSBC Mortg. Servs,, Inc., 744 F.3d 1, 9-10 (1st Cir. 2014) (agreements induced by fraudulent misrepresentation are voidable); Berwind Prop. Grp. Inc. v. Envtl. Mgmt. Grp., Inc., Civil Action No. 04-11411-NMG, 2007 WL 4707647, at *3 (D. Mass. Feb. 5, 2007) (same); see also W. Capital Partners, LLC v. Allegiance Tit. & Escrow, Inc., 520 F. Supp. 2d 777, 781 (E.D. Va. 2007) ("When a party's assent to a contract is obtained by fraud, the contract is voidable.").

Similarly, the utilization by the Promoter-Participant of the "credits" previously issued to that Participant were not property. Not only were they a mere element of the Ponzi/pyramid scheme, but the credit had no value or utility outside of perpetrating the fraud. See SUF ¶ 19,

Exhibit N at 54:14-16, Exhibit O at ¶ 35. The obvious proof of the utter lack of value of these credits is to ask the following question: What could TelexFree have done if the Promoter-Participant failed or refused to "transfer" its credit to TelexFree in "satisfaction" of the "invoice" from TelexFree to the Victim-Participant? As shown above, TelexFree could not sue the Victim-Participant and compel payment to it, as the invoice was the product and tool of fraud. Even assuming the Promoter-Participant had an obligation to turn over any money received from a Victim-Participant to TelexFree, and instead had taken the money for himself or herself, TelexFree could not bring a claim against the Promoter-Participant for either the credits or the money itself because both were (witting or unwitting) parties to the fraud. See Shearman Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) ("[W]hen a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee cannot recover against the third party for the damage to the creditors."); Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Invs. Secs. LLC), 721 F.3d 54, 63 (2d Cir. 2013) ("Picard I") (trustee appointed in Madoff Ponzi scheme could not bring claims of creditors against third parties for unjust enrichment, breach of fiduciary duty, aiding and abetting fraud and negligence, among others, because, "the doctrine of *in pari delicto* bar[s] a debtor from suing third parties for a fraud in which he participated").

In short, inasmuch as both the "invoices" and "credits" were mere fabricated tools to perpetrate the fraudulent scheme, the Trustee's reliance on the collapsible transaction cases literally collapses under its own logic. In *every* collapsible transaction case cited previously by the Trustee in connection with the *Motion by Chapter 11 Trustee for Entry of Order Finding That Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief* (the "Ponzi Scheme Motion"), Case No. 14-40987 [Docket No. 623], the transfers of property involved property to

which the debtor had valid legal title. None were cases in which the debtor's only claim to title was itself predicated upon fraud. For example, the Trustee cited to several cases in which courts collapsed transactions in the context of leveraged buyouts. In each of these cases, the target company had a *legal right* to the proceeds of the loan secured by the transfer of an interest in its tangible assets that were themselves legally owned. See CPY Co. v. Ameriscribe Corp. (In re Chas P. Young Co.), 145 B.R. 131 (Bankr. S.D.N.Y. 1992) (purchaser used assets of the target to finance acquisition); OODC, LLC v. Majestic Mgmt., Inc. (In re OODC, LLC), 321 B.R. 128 (Bankr. D. Del. 2005) (purchaser used assets of target to finance acquisition); U.S. v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986) (purchaser's loan secured by assets of target), cert. denied, McClellan Realty Co. v. U.S., 483 U.S. 1005 (1987); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988) (purchaser financed acquisition using target's assets); Murphy v. Meritor Savs. Bank (In re O'Day Corp)., 126 B.R. 370 (Bankr. D. Mass. 1991) (purchaser's loan secured by target's assets); Jevic Holding Corp. v. The CIT Grp. (In re Jevic Holding Corp.), Bankruptcy No. 08-11006 BLS, 2011 WL 4345204 (Bankr. D. Del. Sept. 15, 2011) (purchaser used assets of the target to finance acquisition).

The Trustee also previously cited to two similarly inapposite cases outside of the leveraged buyout context. Both of these cases involved a situation in which the debtor sold its *validly owned* assets, but allowed a portion of the sale price to be paid to a third party. See Food Catering & Housing, Inc. v. Chemcarb, Inc. (In re Food Catering & Housing, Inc.), 971 F.2d 396 (9th Cir. 1992) (purchaser of debtor's assets, as component of purchase price otherwise payable to the debtor, assumed and then paid the debtor's liability to a third party); Warsco v. Preferred Tech. Grp., 258 F.3d 557 (7th Cir. 2011) (asset purchaser satisfied note

issued by debtor as part of asset sale). Neither of these cases support the Trustee's right to recover monies to which the Trustee never had a legal right or valid title. Finding trustee standing in these decisions required no novel expansion of the law; each case was predicated on the loss of something to which the debtor was legally entitled in favor to a preferred creditor or for less than fair value.

Another way to prove the emptiness of the Trustee's argument is to ask whether the transfer of fabricated "credits" by the Promoter-Participant to TelexFree in "satisfaction" of the Victim-Participant's phony invoice resulted in diminution the TelexFree's estates. See Picard v. Fairfield Greenwich Ltd., 762 F.3d 199, 208 (2d Cir. 2014) ("Picard III") ("A fraudulent conveyance (or fraudulent transfer) action seeks to recover or avoid transfers that wrongfully reduce the pool of asset available to creditors."); Marshall v. Picard (In re Bernard L. Madoff Invs. Secs. LLC), 740 F.3d 81, 93 (2d Cir. 2014) ("Picard II") (enjoining creditors' claims against third parties because claimed damages were "mere secondary harms flowing from the [] defendants' fraudulent withdrawals and the resulting depletion of BLMIS funds"); see also Warsco, 258 F.3d at 564 (courts considering whether property is property of the debtor "have focused on whether the transfer diminished the debtor's estate"); In re Baker & Getty Fin. Servs. Inc., 98 B.R. at 305 ("A transfer is avoidable as a preference only if the transferred property or interest in property diminished or depleted the debtor's estate.").

Unlike the transactions at issue in these cases, the Debtors here did not experience any diminishment in the value of their estates in connection with the Participant-to-Participant Payments. The Trustee plainly ignores the fact that the issuance of any particular credit did not diminish TelexFree's ability to simply fabricate additional credits as the need arose. See SUF ¶ 18-19, Exhibit N at 54:14-16, Exhibit O at ¶ 35. The "credits" issued by TelexFree were merely

constructs of an illegal scheme and manufactured at will to perpetuate that scheme. TelexFree did have possession, and hence voidable title, of the cash paid to it directly by certain victims; but those monies are not the subject of the PIEC's claims or what the Trustee now wrongly seeks to enjoin.

While it is true that a Victim who made a Participant-to-Participant Payment, thereby gaining entry into the TelexFree scheme, could later recruit additional Participants and receive cash from these Participants, this fact also does not establish that the Trustee had a legal right to the Participant-to-Participant Payments. See SUF ¶ 13, 16, Exhibit M at ¶¶ 11, 17-18. As the perpetrators of an illegal scheme, the Debtors never had a right to possess or compel payment of the Participant-to-Participant Payments. Had a Participant failed to pay any promised funds to another participant, the Debtors would have had no legal recourse to compel such payment.

Given that the Participant-to-Participant Payments were transactions between non-debtors and did not involve any property of the Debtors' estate, other than "property created by fraud," the Trustee, cannot, through the artifice of "collapsing" the transaction, turn an illegal claim to property into a legal one. Thus, the Trustee lacks standing to pursue the recovery of the funds involved in the Participant-to-Participant Payments under the Bankruptcy Code.

## II. The Trustee Is Not Authorized To Sue Third Parties On Behalf Of Creditors Suffering Particularized Injury

The Trustee's assertion of a stay violation is also baseless because the PIEC claims are direct claims for particularized injuries of the Victims it represents -- not disguised fraudulent transfer claims. There can be no serious dispute that a claim for injury that is particular to certain creditors, rather than general to all creditors, may be brought *only* by the injured creditors. See Picard III, 762 F.3d at 211 ("[W]hen creditors . . . have a claim for injury that is particularized as to them, they are exclusively entitled to pursue that claim, and the bankruptcy

trustee is precluded from doing so."); Wagoner, 944 F.2d at 118 ("It is well-settled that a bankruptcy trustee . . . may only assert claims held by the bankrupt corporation itself.").

The question here, then, is necessarily whether the Victims' unjust enrichment claims seek to recover for direct, particularized harm. They unequivocally do. The Second Circuit's most recent analysis in the *Picard* trilogy of cases is particularly illuminating. In *Picard III*, the Second Circuit addressed the right of victims of the Madoff Ponzi scheme to bring breach of fiduciary duty and other claims against investment funds that invested the victims' assets with Madoff. See 762 F.3d 199 (2014) (*Picard III)*. As the court stated there, "In order to qualify as 'disguised fraudulent transfer actions,' . . . the complaints . . . would have to be contingent on [the debtors'] wrongful transfer of the funds sought" in those actions. Id. at 209. In rejecting that characterization, the court concluded that the non-debtor defendants owed independent duties to their customers, and their liability to customers was not dependent on Madoff's liability to investors. See id. at 209. As a result, the customers' claims were not "disguised" fraudulent transfer claims because, although the Madoff scheme may have been the "but-for" cause of the customers' losses, the claims against the funds were independent of claims against Madoff. See id. at 210. Moreover, the court found that the claims were not dependent on funds wrongfully transferred by the debtors to the non-debtor third parties. Id. at 209. The unjust enrichment claims brought now by the Victims here are even further removed than those in *Picard III*, as the TelexFree Debtors made no transfers of any property whatsoever to the Promoter-Participants.

Similarly, in *Picard I*, 721 F.3d 54, 67-70 (2d Cir. 2013*) (Picard I)*, the Second Circuit denied the trustee standing to bring unjust enrichment claims on behalf of creditors of Madoff's Ponzi scheme against third parties because the asserted claims were based upon the defendants' "handling of individual investments made on various dates in varying amounts." Here, the PIEC

is bringing unjust enrichment claims on behalf of victims against non-debtor promoters in the exact amount of the Participant-to-Participant Payments passing between any given two. In other words, the Victims' claims are for the direct harm they suffered at the hands of the promoter with whom they interacted. See also In re Park S. Sec. LLC, 326 B.R. 505, 513-14 (Bankr. S.D.N.Y. 2005) (holding that trustee could not bring unjust enrichment claims under section 105(a) of the Bankruptcy Code and stating that "absent another basis for standing, the Trustee may not pursue a claim on the estate's behalf if it is particular only to certain creditors").

By contrast, the Victim-Participants' unjust enrichment claims are unlike the claims brought by individual creditors in *Picard II*, 740 F.3d 81 (2d Cir. 2014) *(Picard II)*, which the Second Circuit found were derivative of the estate's claims. There, the creditors attempted to sue Madoff's co-conspirators to recover funds that the defendants had improperly withdrawn from the debtors' possession (i.e., BLIMS accounts). Id. at 85. The Second Circuit concluded that the claims were in fact derivative of the estate's claims and not "particularized" as to the individual creditors because their alleged injuries were "inseparable from, and predicated upon, a legal injury to the estate, namely the [] defendants' fraudulent withdrawals from their BLMIS accounts of what turned out to be other BLMIS customers' funds." Id. at 92. The court emphasized that the reason the claims by creditors were not "particularized" as to them was because there were no allegations that the defendants "directly participated in defrauding BLMIS customers by inducing them to invest." Id. at 93. That allegation missing there is of course the gravamen of the Victim-Participants' claims against the Promoter-Participants. Here, the Victim-Participants and Promoter-Participants directly interacted with one another in the actual transaction that resulted in the Participant-to-Participant Payment; that is, the Promoter-Participants directly induced the Victim-Participants to pay them (the Promoter-Participants)

money. Thus, unlike the creditors in *Picard II*, the Victims here seek to recover against the Promoter-Participants at whose hands they suffered direct and particularized harm, in the form of Participant-to-Participant Payments which had no impact whatsoever on the Debtors' estate.

Simply put, the Victims' unjust enrichment claims, then, are not merely "disguised" fraudulent transfer claims. Like the customers in *Picard III*, TelexFree's fraud may have been the "but-for" cause of Victims' losses, but the Victims' claims are not dependent on TelexFree's liability to creditors. The TelexFree scheme was the apparatus that facilitated the Participant-to-Participant Payments, but its existence does not shield the Promoter-Participants from liability for their own tortious conduct. A Victim took cash from his or her own pocket and paid it under false pretenses to the Promoter-Participants who were thus unjustly enriched. See SUF ¶ 16, Exhibit M at ¶¶ 17-18. No other creditor has any interest in that specific cash payment or suffered from that injury; and those monies were never transferred to the Debtors or commingled with the assets of TelexFree as to render them untraceable. A Victim's right to recover illegally taken cash belongs solely to the Victim and the Trustee may not assert these claims.

The fact that the wrongs committed by the Promoter-Participants against the Victim-Participants are bound up with the Ponzi scheme promoted by TelexFree does not change the result. While TelexFree may have conspired with or aided and abetted the Promoter-Participants' wrongful conduct and thus *also* wronged the Victim-Participants, those wrongs are independent and do not affect the claims by the Victim-Participants against the Promoter-Participants. As the Second Circuit held in *Picard III*, "that plaintiffs in both [state court] Actions are creditors of the Madoff estate…[is irrelevant as] the plaintiff's right to enforce duties owed to them is not qualified by the fact that they may also have claims against the Madoff estate." *Picard III*, 762 F.3d at 21; see also *Picard II*, 740 F.3d at 91 ("'[T]here is nothing

illogical or contradictory about saying that [a third-party defendant] might have inflicted direct injuries on both the [estate's creditors] and [the debtor estate] during the course of dealings that form the backdrop of both sets of claims.'" (citation omitted)).

Based on the foregoing, the Trustee has no standing to sue to recover the Participant-to-Participant Payments on behalf of TelexFree's creditors and granting the relief requested in the Adversary Proceeding would constitute a novel and inappropriate expansion of the Trustee's powers under the Bankruptcy Code.

## CONCLUSION

The Trustee's attempt to enjoin the PIEC from maintaining the direct and particularized claims of the Victim-Participants is bedeviled by the singular fact that the Debtors never had possession of the Participant-to-Participant Payments. Those direct payments simply are not, and never were, property of the Debtors or their bankruptcy estate. Why did TelexFree structure its fraudulent scheme as a hybrid Ponzi/pyramid scheme such that only some monies ($390,000,000) were paid directly to Debtors, while the rest ($2 billion+) were paid directly by Victims to non-debtor promoters? Who knows! But that "why" is irrelevant. Because the payments were always the product of a fraud, TelexFree never had right to title to any monies. Only possession could give it colorable title; without possession it owned nothing. And because the Debtors never had possession of the Participant-to-Participant Payments, they never had the opportunity to commingle those payments into an indistinguishable pool, and never had the chance to thereafter make payments from that pool. Instead, the Participant-to-Participant Payments were the product of one-on-one interactions between Victims and non-debtor promoters and thus the claims are particularized to those Victims. The Trustee lacks standing to usurp their prosecution. Accordingly, the Trustee's complaint should be dismissed, in its entirety and with prejudice.

Dated: August 5, 2016
Boston, Massachusetts

**BONSIGNORE, PLLC**

*/s/ Robert J. Bonsignore*
Robert J. Bonsignore
NH Bar 21241
3771 Meadowcrest Drive
Las Vegas, Nevada 89121
Telephone: 781-856-7650
rbonsignore@classactions.us
*Interim Lead Counsel*

**BROWN RUDNICK LLP**

*/s/ William R. Baldiga*
William R. Baldiga (BBO #542125)
James W. Stoll (BBO # 544136)
Jill C. Wexler (BBO #691811)
One Financial Center
Boston, MA 02111
Telephone: (617) 856-8200
Facsimile: (617) 856-8201
wbaldiga@brownrudnick.com
jstoll@brownrudnick.com
jwexler@brownrudnick.com
*For the Plaintiffs' Interim Executive Committee*

**CERTIFICATE OF SERVICE**

The undersigned certifies that on August 5, 2016, the foregoing document was filed electronically, and therefore was sent by email to those receiving CM/ECF notices from the Court's electronic filing system. I further certify that I have caused to be sent by first class mail a copy to the following parties on this 5th day of August, 2016.

Charles R. Bennett, Jr., Esq.
Murphy & King, Professional Corporation
One Beacon Street
Boston, MA 02108

Richard King, Asst. United States Trustee
Office of the United States Trustee
446 Main Street
14th Floor
Worcester, MA 01608

/s/ Carol S. Ennis
Carol S. Ennis

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