Docket #0076 Date Filed: 12/20/2016

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS
CENTRAL DIVISION

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.	)	

PIEC'S RESPONSE TO MEMORANDUM OF LAW IN SUPPORT OF TRUSTEE'S OPPOSITION TO PIEC MOTION FOR SUMMARY JUDGMENT AND TRUSTEE'S CROSS-MOTION FOR SUMMARY JUDGMENT

INTRODUCTION

As demonstrated in the *Memorandum in Support of PIEC's Motion for Summary Judgment* [Docket No. 41] (the "PIEC Opening Brief"), and as admitted by the Trustee, TelexFree never acquired or held any legal title to the monies transferred as Participant-to-

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

Participant Payments. Further, TelexFree never had actual possession of the Participant-to-Participant Payments and all of these Payments were the product of a fraud.[2] Accordingly, none of those Payments ever became property of the estate.

Conceding, finally, that TelexFree lacked possession of the Participant-to-Participant Payments, and that the absence of possession makes it impossible for the estate to have acquired legal title to these payments, the Trustee has now come up with a new theory: "agency." Although the Trustee did not plead agency in his Complaint, he now argues that the Participant-to-Participant Payments were collected by the Promoter-Participants as "agents" of TelexFree, and that once these payments were collected by the Promoter-Participants it was *as if* the money had reached the hands of TelexFree. This new theory of the Trustee's case is a last-ditch effort that does not withstand the slightest scrutiny.

The issue to be decided here is a serious one. It determines the rights of hundreds of thousands of individual victims, most of whom are of very modest means, to sue in their own names to recover for themselves the cash that they handed over to Promoter-Participants. In many instances, that cash was a major part of each victim's life savings, the victim knows who they gave the cash to, and the victim wants desperately to sue to get it back from those who wrongfully and unjustly were enriched by the receipt.

The Trustee is trying to take to himself each victim's right to do that, to settle out or otherwise do as he wishes with them, but not in accordance with the victims' directions. The Supreme Court, in Caplin v. Marine Midland Grace Tr. Co. of N.Y., 406 U.S. 416 (1972), and its progeny, has dictated that a trustee must satisfy very specific and exacting requirements to have standing to sue Promoter-Participants to recover the monies transferred to them by individual

[2] Capitalized terms used but not defined herein shall have the meanings ascribed to them in PIEC Opening Brief.

Victim-Participants: (1) *possession* of the Participant-to-Participant Payments; and (ii) a *legal right* to the Participant-to-Participant Payments.

The Trustee's *Memorandum of Law in Support of Trustee's Opposition to PIEC Motion for Summary Judgment and Trustee's Cross-Motion for Summary Judgment* [Docket No. 51] makes plain that the Trustee cannot meet this standard. Instead, the Trustee now offers a novel and factually unsupported expansion of "agency" law in an attempt to circumvent the requirements of Caplin and manufacture standing. This attempt must fail. The Trustee has not demonstrated that TelexFree's contracts with Promoter-Participants (the "Promoter Contracts")[3] created in TelexFree either possession of or a legal right to the Participant-to-Participant Payments. The Promoter Contracts were an integral part of TelexFree's fraud and accordingly were unenforceable and, moreover, unenforced. TelexFree could not have compelled the Promoter-Participants to turn over the Participant-to-Participant Payments to TelexFree under the fraudulent Promoter Contracts, and never so much as attempted to do so. Furthermore, even if one ignores the complete bar imposed on the Trustee by the doctrine of *in pari delicto*, the Promoter Contracts did not establish an agency relationship between the Promoter-Participants and TelexFree. Those Contracts demonstrate that the Promoter-Participants did not act for the benefit of TelexFree, were not subject to TelexFree's control, and had no authority to legally bind TelexFree.

As made clear in the PIEC Opening Brief, the Victim-Participants' claims against each Promoter-Participant are independent of their claims against TelexFree, because each Victim suffered a personal and particularized injury at the hands of the Promoter-Participants to whom he or she transferred money. The Trustee, however, now argues that the individual Victim-

[3] A copy of a Promoter Contract is attached to the *Trustee's Statement of Undisputed Material Facts in Support of His Cross-Motion for Summary Judgment*[Docket No. 48] (the "Trustee SUF") as Exhibit C.

Participants suffered no particularized harm at the hands of Promoter-Participants and so lack standing to recover the money they lost. For that to be true, the Trustee would need to show that the funds were paid to the Debtors, rather than paid to or held by the Promoter-Participants individually, and thereafter transferred by the Debtors to third parties. But, the Trustee cannot overcome the uncontroverted facts that the individual Victim-Participants instead paid over the cash comprising the Participant-to-Participant Payments directly to individual Promoter-Participants and that TelexFree suffered no diminishment of its estate in connection with the Participant-to-Participant Payments. The Trustee simply cannot show here the critical fact necessary to eliminate particularized harm: possession by TelexFree of the Participant-to-Participant Payments, and the late development of a factually unsupported "agency" theory of the case does not supply that critically missing fact.

Finally, in a last-ditch effort to arrogate to himself the rights of a million individuals to assert direct claims on their own behalf, the Trustee finally argues that granting the Victim-Participants standing to recover the Participant-to-Participant Payments would be inconsistent with the Court's *Supplemental Order Respecting Motion by Chapter 11 Trustee for Entry of Order Finding That Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief* [Docket No. 687] (the "Ponzi Scheme Order").[4] As the Court no doubt remembers from the prior extensive presentations on this very issue, the Ponzi Scheme Order has no bearing on the issue in this case: it addresses only the *distribution* of funds, not which party has the right to *recover* funds.

In support of this Response, the PIEC incorporates the facts set forth in the *Memorandum in Support of PIEC's Motion for Summary Judgment* [Docket No. 41] and *Local Bankruptcy*

[4] The Ponzi Scheme Order is attached to the Trustee SUF as Exhibit E.

Rule 7056-11 Statement of Undisputed Material Facts in Support of PIEC's Motion for Summary Judgment [Docket No. 40] (the "PIEC SUF"). As there are no material facts in dispute, granting summary judgment in favor of the PIEC is appropriate.

ARGUMENT

The Trustee does not dispute that TelexFree never had actual possession of the Participant-to-Participant Payments, or that under Caplin the Trustee may not sue the non-debtor Promoter-Participants to recover Participant-to-Participant Payments on behalf of Victim-Participants in their capacity as TelexFree's creditors. Caplin, 406 U.S. at 428 (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); see 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).

The Trustee seeks to side-step Caplin by arguing that the Promoter-Participants received the Participant-to-Participant Payments as agents of TelexFree, and that TelexFree therefore had possession of, and a legal right to, these payments, or at least something close enough to that to escape its reach. To the contrary, the Victim-Participants paid money directly to Promoter-Participants, this money was never transferred from the possession of the Promoter-Participants to the possession of TelexFree, and Victims received nothing of value from TelexFree. See PIEC SUF ¶ 16, Exhibit M ¶¶ 14-18; PIEC SUF ¶ 18, Exhibit N at 54:14-16, Exhibit O at ¶ 69. Granting the relief requested in this Adversary Proceeding would amount to an impermissible

expansion of agency law and a complete violation of the rights of individual Victim-Participants who suffered injury at the hands of the Promoter-Participants.

I. The Promoter-Participants Were Not Agents of TelexFree and Caplin Does Not Authorize the Trustee to Recover the Participant-to-Participant Payments.

The Trustee had neither *possession* of nor a *legal right* to the Participant-to-Participant Payments and is therefore not authorized to recover these payments on behalf of Victim-Participants under Caplin. Furthermore, the Promoter Contracts were unenforceable as part of TelexFree's fraudulent scheme, and did not give TelexFree a legal right to the Participant-to-Participant Payments. Further, and even if the Trustee could demonstrate the enforceability of the Promoter Contracts, these contracts by their terms do not create an agency relationship between TelexFree and the Promoters or imbue the Trustee with standing to recover the Participant-to-Participant Payments.

A. TelexFree, and therefore the Trustee, never had possession of or an enforceable legal right to the Participant-to-Participant Payments.

Conceding as he must that TelexFree never had actual possession of the Participant-to-Participants Payments which in fact were transferred directly from Victim-Participants to Promoter-Participants, the Trustee now attempts to generate possession by invoking the concept of "agency." He argues that the Promoter-Participants collected the Participant-to-Participant Payments on behalf of TelexFree, such that TelexFree had legal title to the money. In the Trustee's version of agency, the contract between TelexFree and the Promoter-Participants created "legal title" to the Participant-to-Participant Payments, which, he argues, is the equivalent of possession. However, the Trustee cites no support for this use of agency law and his belated agency arguments do not and cannot overcome the Trustee's lack of possession of the Participant-to-Participant Payments.

The Trustee argues that it was *as if* the Participant-to-Participant Payments were paid to TelexFree, based on the Promoter Contracts between TelexFree and the Promoter-Participants. The Promoter Contracts, however, were part and parcel of TelexFree's fraudulent scheme and, therefore, unenforceable as a matter of law. 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); 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."). The Trustee cannot recast the illegal contracts with the Promoter-Participants, which could not create legal title, into a legitimate, legal relationship by arguing that there was an "agency" relationship between Promoters and TelexFree.

The Participant-to-Participant Payments were made by individual Victims to non-debtor third parties. TelexFree had no right to enforce these fraudulent contracts and compel the Promoters to turn over the Participant-to-Participant Payments. Therefore, even if the Promoter Contracts created an agency relationship, as the successor to TelexFree, the Trustee would still have no legal right to the cash transferred by Victims as Participant-to-Participant Payments. 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).

Furthermore, even assuming that each Promoter-Participant acted as an agent of TelexFree and was obligated to turn over money received from Victims, the doctrine of *in pari delicto* would nonetheless bar the Trustee from bringing a claim against those Promoter-Participants. 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"). If the Promoter Contracts created an agency relationship, they did so only in the context of a fraudulent scheme. The Trustee therefore cannot now, and TelexFree never attempted to, enforce these Contracts to recover the Participant-to-Participant Payments.

Finally, even after a year of briefing and argument on these issues, the Trustee remains unable to cite to a single case in support of his analogy to leveraged buyouts (in which transfers of property are collapsed into a single transaction where the debtor *possessed* and had a *legal right* to the property). It also cannot escape the Court that the Trustee tellingly did not plead agency in his Complaint. Rather, still finding no case law support of any type, the Trustee now grasps at this "agency" argument solely because his original collapsing theory was exposed as untenable in the PIEC Opening Brief. It remains the case, simply but powerfully, that when a party defrauds another of his property, title acquired by the fraudster over that property is never more than "possessory title"; that is, because the transfer is the product of fraud, only actual

possession of the ill-gotten property can convey any sort of property interest. This fundamental principle of law continues to stand squarely in the path the Trustee tries to find to block victims from their proper exercise of their own rights of recovery.

B. The Promoter Contracts do not create an agency relationship between the Promoter-Participants and TelexFree.

Even if the Court ignores the complete bar imposed on the Trustee in this case by the doctrine of *in pari delicto*, the Promoter Contracts themselves make clear that there was no agency relationship between the Promoter-Participants and TelexFree in any event. Under agency law, an agent must: (i) act on behalf of and for the benefit of the principal; (ii) be subject to the principal's control; and (iii) have the authority to bind the principal. See Theos & Sons, Inc. v. Mack Trucks, Inc., 431 Mass. 736, 742 (Mass. 2000) ("[a]n agency relationship is created where there is mutual consent, express or implied, that the agent is to act on behalf of and for the benefit of the principal, and subject to the principal's control"); Motorsport Engineering, Inc. v. Maserati SPA, 316 F.3d 26, 29-30 (1st Cir. 2002) ("[a]n agent is simply someone who is authorized by the principal to act on the principal's behalf and bind the principal as if the latter were there himself"); Restatement (Second) of Agency § 14 ("A principal has the right to control the conduct of the agent with respect to matters entrusted to him.").

The Promoter Contracts nowhere say, and the Trustee fails to cite to any provision, that the Participant-to-Participant Payments are being collected by Promoter-Participants "on behalf of" or "for the benefit of" TelexFree. The Trustee merely argues that the Promoter Contracts "expressly authorize the use of a Promoter's credits to satisfy the invoice of the new recruits." [Docket No. 51] at 15. In fact, the Promoter Contracts explicitly state that the Promoters are not employees of TelexFree, not subject to the control of TelexFree, and not authorized to act in the name of TelexFree. For example, under Section 2.4.1, "PROMOTERS do not have employment

relationship, inasmuch as their working regimen is autonomous, free of any imposition of routines, goals or regulation, and there is no hierarchical relationship or geographic area, and must, however, diligently seek to preserve the good name, image and brand of TELEXFREE." And, under Section 2.4.3, "[t]he PROMOTER is expressly notified that it is prohibited for him to present himself as acting in the name of TELEXFREE in relation to public or private institutions, nor is he authorized to make purchases or sign commitments or obligations on behalf of TELEXFREE, YMPACTUS." Once again, the facts here provide no help to the Trustee.

These provisions do though make clear that the Promoter Contracts do not create an agency relationship between TelexFree and the Promoter-Participants. The Promoter-Participants were not "acting in the name of TELEXFREE." TelexFree seemingly took pains to ensure that the Promoter-Participants were acting autonomously and unable to legally bind TelexFree to any obligations to third parties. In contrast to the facts here, an agency relationship requires the agent be subject to the principal's control. This is not established by the Promoter Contracts.

Over the course of the TelexFree scheme, billions of dollars were transferred as Participant-to-Participant Payments. The great bulk of these dollars were never turned over to TelexFree. Nonetheless, the Trustee claims that these billions of dollars were collected by Promoter-Participants on behalf of and for the benefit of TelexFree. In reality, TelexFree never tried to enforce its "rights" to funds collected by Promoter-Participants and never received, possessed or controlled these funds. Given the billions of dollars at stake, it's ludicrous to suggest that the Promoter-Participants collected these funds as agents of TelexFree.

II. The Trustee Has No Authority to Sue Third Parties on Behalf of Creditors Suffering Particularized Injury.

As noted above, and as mandated by the Supreme Court in Caplin, only the Victim-Participants have standing to recover the Participant-to-Participant Payments because each

Victim-Participant suffered direct harm at the hands of, and has an independent claim against, the one or more Promoter-Participants to whom he or she made payments. The Trustee next tries to escape the dictates of Caplin by arguing that the Victim-Participants do not have standing to recover those Payments because they did not suffer a particularized harm. In support of his argument, the Trustee cites to three decisions. However, and showing how far the Trustee has to reach here to find some way around Caplin, in EACH of those three cases all payments were made directly to fraudulent schemer. See Ritchie Capital Mgmt., LLC v. Gen. Elec. Capital Corp., 821 F.3d 349 (2d Cir. 2016) (no particularized harm where creditors made all payments directly to schemer, but sought to recover funds from third party based on third party's payment to schemer); In re Barkany, 542 B.R. 662 (E.D.N.Y. 2015) (no particularized harm where there were two related investment schemes and each had different victims, but the investment schemes were conducted by same individual and all payments were made to same individual); Meoli v. The Huntington Nat'l Bank (In re Teleservices Grp., Inc.), 463 B.R. 28 (W.D. Mich. 2012) (no particularized harm where only transfer at issue was direct transfer to debtor with respect to which trustee had standing to bring fraudulent transfer claim).

The facts of these cases stand in stark contrast to the facts here: Victims made payments directly to individual Promoter-Participants, the funds so transferred were never possessed by TelexFree or commingled with TelexFree's other funds, and the payment of these funds did not result in any diminishment of TelexFree's estate. See PIEC SUF ¶ 16, Exhibit M ¶¶ 14-18; PIEC SUF ¶ 18, Exhibit N at 54:14-16, Exhibit O at ¶ 69. In each of the cases cited by the Trustee, the court found that the individual creditors had not suffered particularized harm. But, in each of these cases, the creditors sought to recover money that had been paid directly to the schemer and

then transferred out to a third party. (Of course, the PIEC has never attempted to reach transfers of whatever cash was at some point in the possession of TelexFree.)

In another far reach, The Trustee next mischaracterizes the holdings of a trio of decisions coming out of the Madoff Ponzi scheme. The Trustee suggests that, under these decisions, payments made by creditors to non-debtor third parties somehow constitute harm to the debtor, such that the creditors suffered merely non-particularized, secondary harms. These decisions, however, make clear that non-particularized injuries are only those injuries that have some effect on the debtor's estate.

The Trustee first cites to Marshall v. Picard (In re Bernard L. Madoff Invs. Secs. LLC), 740 F.3d 81 (2d Cir. 2014) ("Picard II"). The creditors in Picard II sought to sue Madoff's co-conspirators to recover funds that those defendants had improperly withdrawn from the debtors' possession. Id. at 85. There, the court concluded that the creditors' claims against third party co-conspirators were not particularized because the claimed damages were "mere secondary harms flowing from the [] defendants' fraudulent withdrawals and the resulting depletion of BLMIS funds." Id. at 92. Here, in contrast, the Victim-Participants seek to recover funds paid directly to the Promoter-Participants in the form of Participant-to-Participant Payments that had no impact on TelexFree's estate. See PIEC SUF ¶ 16, Exhibit M at ¶¶ 17-18; PIEC SUF ¶ 18, Exhibit N at ¶ 54:14-16, Exhibit O at ¶ 69.

Second, the Trustee cites to The Lautenberg Foundation v. Picard (In re Bernard L. Madoff Inv. Secs., LLC), 512 Fed. Appx. 18 (2d Cir. 2013) ("Picard III"), in which the Second Circuit enjoined creditors' claims against employees of the Madoff scheme. As the lower court made clear, the creditors "assert[ed] violations of duties owed derivatively to all customers and creditors by virtue of the Madoff Defendants' positions generally at BLMIS, the breach of which

resulted in losses to all Madoff victims." Secs. Inv. Protection Corp. v. Bernard L. Madoff Inv. Secs. LLC, 443 B.R. 295, 312 (S.D.N.Y. 2011), aff'd 512 Fed. Appx. 18 (2d Cir. 2013). Unlike the Picard III creditors, the harm suffered by the Victim-Participants did not result in a loss to all TelexFree Victims because TelexFree's estate suffered no diminution in value as a result of the Participant-to-Participant Payments or the issuance of valueless "credits" to Victims or Promoters. See PIEC SUF ¶ 18, Exhibit N at 54:14-16, Exhibit O at ¶ 69.

Finally, the Trustee cites to Picard v. Fairfield Greenwich Ltd., 762 F.3d 199 (2d Cir. 2014) ("Picard IV"). In Picard IV, the Second Circuit addressed the right of the Madoff Ponzi scheme victims to bring breach of fiduciary duty and other claims against brokerage companies that invested the victims' assets with Madoff. The court concluded that these victims had the right to bring their own claims, because:

- the victims' complaints were not contingent on the debtors' wrongful transfer of funds;
- the non-debtor third-party defendants owed independent duties to their customers;
- the defendants' liability to the customer-victims was not dependent on Madoff's liability to investors;
- the claims against the defendants were independent of claims against Madoff; and
- the claims were not dependent on funds wrongfully transferred by the debtors to the non-debtor third parties.

See id. at 209-10. Here, the Victims' claims against TelexFree are likewise separate and distinct from their claims against the Promoter-Participants and do not depend on a determination of TelexFree's liability to Victims. And, the Victims' claims are not dependent on transfers of any property whatsoever from the Debtors to the Promoter-Participants. Like the creditors' claims in Picard IV, the unjust enrichment claims brought by the Victim-Participants are grounded on a

particularized harm suffered by these claimants at the hands of third parties. It seems clear that the Madoff courts, including the Second Circuit, would have easily disposed of the Trustee's arguments here for all of the same reasons. And, there is no law, found by the PIEC or cited by the Trustee, to the contrary.

Based on the foregoing, the Trustee has failed to refute that the Victim-Participants' claims to recover Participant-to-Participant Payments are particularized as to them, the Victim-Participants are "exclusively entitled" to pursue these claims, and "the bankruptcy trustee is precluded from doing so." Picard IV at 211.

III. The Ponzi Scheme Order Does Not Grant the Trustee Authority to Sue to Recover Participant-to-Participant Payments.

The Trustee finally argues that the Court, through the Ponzi Scheme Order, has already in effect decided the critical questions at issue in this case: whether the Participant-to-Participant Payments constitute property of the Debtors' estate and, relatedly, whether the Trustee has authority to sue to recover Participant-to-Participant Payments. The Trustee suggests that the Ponzi Scheme Order creates standing where none otherwise exists. In reality, that Order has no bearing on this dispute. The Court in fact declined to enter a finding requested by the Trustee that the Participant-to-Participant Payments constituted property of the estate. On January 19, 2016, the Trustee filed the *Proposed Supplemental Order Respecting Motion by Chapter 11 Trustee for Entry of Order Finding That Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief* (the "Proposed Supplemental Ponzi Order"). See Exhibit A to *Memorandum in Support of Proposed Supplemental Order Respecting Motion by Chapter 11 Trustee for Entry of Order Finding That Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief* [Docket No. 677], Case No. 14-40987.[5] In the Proposed Supplemental Ponzi Order, the Trustee requested a

[5] A true and accurate copy is attached hereto as **Exhibit A**.

finding that "The payment made by a recruited Participant in a Triangular Transaction is a transfer of property of the Debtors' Estates and should be included in the calculation of Net Equity." Proposed Supplemental Ponzi Order, at ¶ 5(ii). The Court, however, declined to enter this finding as part of the Ponzi Scheme Order. The Ponzi Scheme Order only provides that claims in the Chapter 11 case shall be determined on a "Net Equity" basis. It does not address whether the Participant-to-Participant Payments are property of the estate or which party has the right to pursue which claims or to recover funds from "Net Winners" in the TelexFree scheme.

In addition, the Trustee presupposes that all Victims will elect to file claims in the bankruptcy case. Yet, many Victims, for whatever reasons, may choose not to file claims in the bankruptcy court and to instead sue, individually or as part of a class, to recover the funds they lost on their own behalf. These Victims should not be denied their direct claims to recover on their personal losses because of their decision not to participate in the bankruptcy case.

The Trustee also incorrectly presupposes that all creditors in a bankruptcy case have the same rights as against third parties and will receive equal treatment. But bankruptcy law does not purport to "even out" distributions when some creditors have particularized relief against third parties, such as guarantors, third party tort-feasors, insurers or others. Not all victims of TelexFree's fraud were in an "equal position" in connection with the fraud. Many Victims will have claims not only against TelexFree, but also against individual Promoter-Participants. See, e.g., Picard IV, 762 F.3d at 21 ("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 in not qualified by the fact that they may also have claims against the Madoff estate"); Picard II, 740 F.3d at 91 ("[T]here is nothing illegal or contradictory about saying that [a third-party defendant] might have inflicted direct injuries on both the [estate's creditors] and [the debtor estate] 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)); United States v. Durham, 86 F.3d 70, 73 (5th Cir. 1996) (court denied return of traceable property where all victims of the fraud were in an equal position). Therefore, the Trustee's argument is without basis.

CONCLUSION

The Trustee has no property interest in the Participant-to-Participant Payments. He cannot demonstrate either *possession* of or a *legal right* to these payments. He has moreover failed to demonstrate that the Promoters acted for the benefit and under control of TelexFree, or were able to legally bind TelexFree, as is necessary to prove an agency relationship. Rather, each Victim-Participant suffered a personal and particularized injury at the hands of one or more Promoter-Participants, without entering into any financial transaction with TelexFree. For these reasons, and the other reasons set forth herein, and in the PIEC Opening Brief, the Victim-Participants are the only legally proper parties to pursue recovery of the Participant-to-Participant Payments. The Court should therefore deny the Trustee's request for summary judgment and grant summary judgment in favor of the PIEC.

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Dated: December 20, 2016

Boston, Massachusetts

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CERTIFICATE OF SERVICE

The undersigned certifies that on December 20, 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 20th day of December, 2016.

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/s/ William R. Baldiga
William R. Baldiga

EXHIBIT A

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS

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

MEMORANDUM IN SUPPORT OF PROPOSED SUPPLEMENTAL ORDER RESPECTING MOTION BY CHAPTER 11 TRUSTEE FOR ENTRY OF ORDER FINDING THAT DEBTORS ENGAGED IN PONZI AND PYRAMID SCHEME AND RELATED RELIEF

To the Honorable Melvin S. Hoffman, Chief United States Bankruptcy Judge:

Stephen B. Darr, the duly appointed Chapter 11 trustee (the "Trustee") of the bankruptcy estates of TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc. (collectively, the "Debtors"), respectfully submits this Memorandum in Support of the Proposed Supplemental Order (the "Supplemental Order") Respecting the *Motion by Chapter 11 Trustee for Entry of Order Finding that Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief* (the "Ponzi Motion"). A copy of the proposed Supplemental Order is attached as Exhibit "A" hereto.

PROCEDURAL BACKGROUND

On April 13, 2014 (the "Petition Date"), each of the Debtors filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code ("Bankruptcy Code") with the United States Bankruptcy Court for the District of Nevada ("the Nevada Bankruptcy Court"). The Debtors initially operated as debtors-in-possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code. On the Petition Date, the Debtors filed a motion for joint administration

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of the cases, with TelexFree, LLC designated as the lead case. By order dated April 24, 2014, the order for joint administration was approved.

Prior to the filings, the Commonwealth of Massachusetts, Office of Secretary of State, Securities Division (the "MSD") commenced an investigation into the Debtors' business practices. On or about April 15, 2014, the MSD commenced an administrative proceeding against the Debtors. Also on April 15, 2014, the Securities and Exchange Commission (the "SEC") commenced an action against the Debtors and others in the United States District Court for the District of Massachusetts. The foregoing actions alleged, among other things, that the Debtors were engaged in an illegal Ponzi and pyramid scheme and the fraudulent unregistered offering of securities. Contemporaneously with the commencement of the SEC action, Homeland Securities Investigation ("HSI") seized the Debtors' assets, books, and records. In connection therewith, the federal government seized more than $107,000,000 in cash, including funds on deposit and checks payable to the Debtors, their principals, or their affiliates. Federal authorities have also made forfeiture claims against approximately forty (40) other items of real and personal property standing in the name of the Debtors' principals and their affiliates, including automobiles, real properties, and notes secured by mortgages on real properties.

On or about April 22, 2014, the Office of the United States Trustee filed a motion for the appointment of a Chapter 11 Trustee. On May 6, 2014, the Nevada Bankruptcy Court approved a motion by the SEC to transfer venue, and the cases were transferred to the Court on May 9, 2014. On May 30, 2014, the Court allowed the United States Trustee's motion to appoint a Chapter 11 trustee, and the Trustee was appointed on June 6, 2014.

FACTUAL STATEMENT

The Debtors operated a massive Ponzi and pyramid scheme that involved the sale of membership plans and monthly voice over internet phone packages ("VoIP Package"). A person could become a "Participant" in the Debtors by purchasing a membership plan or VoIP Package. Each time that a Participant purchased a membership plan or VoIP Package, the Debtors established a "User Account" to track the activity of the Participant. There are approximately 11,000,000 User Accounts.

The Debtors provided Participants with two membership plan options, each of which allowed Participants to generate credits totaling up to 200% to 300% of their annual investment merely by posting meaningless internet advertisements. Participants could earn additional credits by selling membership plans. The Debtors also issued credits to Participants for the sale of VoIP Packages, but the revenue generated from the sale of VoIP Packages was insignificant. The overwhelming source of revenue for the Debtors was the membership fees paid by new Participants. Participants had various means to monetize credits; credits could be redeemed by the Participants for cash, or used by Participants to establish other User Accounts for the Participant or someone else.

When a membership plan or VoIP Package was purchased, the Debtor issued an invoice to the Participant. Invoices could be satisfied in one of two ways. A Participant could satisfy the invoice by payment in cash directly to the Debtors (a "Direct Transaction"), or a Participant could satisfy the Debtors' invoice to them by payment to a recruiting Participant who in turn would pay the invoice by redeeming their accumulated credits, and the Debtors marked the invoice as paid and reduced the recruiting Participant's credits by a corresponding amount (a

"Triangular Transaction").[1] Essentially, Participants monetized their accumulated credits by recruiting new Participants through Triangular Transactions. In fact, it was a regular practice of the Debtors and Participants to engage in Triangular Transactions rather than by redeeming credits with the Debtors for cash.

The Ponzi Motion

The Trustee conducted an extensive investigation into the operations of the Debtors' scheme and Participant involvement therein. As a result of the investigation, the Trustee concluded that the Debtors had engaged in a Ponzi and pyramid scheme.

On or about October 7, 2015, the Trustee filed the Ponzi Motion[2] and a motion to approve form of notice of the Ponzi Motion (the "Notice Motion"). Pursuant to the Ponzi Motion, the Trustee sought the following relief:

(i) A finding that the Debtors operated a Ponzi and pyramid scheme;

(ii) An order that any claim or portion of claim of Participants based upon accumulated credits in Participants' User Accounts as of the Petition Date should be disallowed, and that the amount of claims should be determined on a "Net Equity" basis as described herein;

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[1] A Participant could also open new User Accounts for himself/herself and engage in a Triangular Transaction where the Participant owned both the existing User Account and the new User Account. In these intra-Participant transactions, obviously no funds were exchanged, and the Participant was acquiring additional membership plans with accumulated credits in order to enhance opportunities for compensation.

[2] Simultaneously with the filing of the Ponzi Motion, the Trustee also filed his *Motion by Chapter 11 Trustee for Entry of Order Fixing Bar Date for Filing Proofs of Claim, Approving Form and Manner of Notice, Directing that Claims be Filed Electronically, and Approving Content of Electronic Proofs of Claim* (the "Bar Date Motion"). Pursuant thereto, the Trustee sought, among other things, approval for the electronic noticing of a Bar Date, the content of electronic proofs of claim, and the internet portal to be used in the claims process.

(iii) An order that the Debtors should be held jointly and severally liable for the claims of Participants; and

(iv) An order that the findings made pursuant to the Ponzi Motion should be applicable throughout these proceedings, for all purposes.

The Notice Motion was approved at a hearing held on October 14, 2015, and the Trustee provided notice of the Ponzi Motion on or about October 19, 2015. Objections to the Ponzi Motion were filed by the Plaintiffs' Interim Executive Committee (the "PIEC") in the class action complaint pending in the United States District Court and by the Debtors' principals. An evidentiary hearing on the Ponzi Motion was held on November 24, 2015. On November 25, 2015, the Court entered an order, as amended by order dated December 21, 2015, finding that the Debtors operated a Ponzi and pyramid scheme and that this finding was the law of the case. The Court also found that the Debtors were jointly and severally liable for the claims of the Participants and that this finding was also the law of the case. The Court continued until January 26, 2016 the hearing on the Trustee's request that the claims of Participants be determined based upon the "Net Equity" method and issues associated with such a ruling. The Court further directed that the Trustee provide supplemental notice to Participants of the relief requested and of the continued hearing, which was effected by the Trustee on or about December 7, 2015.

ARGUMENT

The Ponzi Motion and the PIEC's opposition raise the following issues: (i) whether credits earned by Participants should be disallowed in determining the amount of Participant claims; (ii) whether the Net Equity standard is the appropriate method for determining the amount of Participant claims, including whether the Triangular Transactions should be included

therein; and (iii) whether the additional relief sought in the Ponzi Motion may be granted without the commencement of an adversary proceeding.

I. Credits should be disallowed.

It is universally accepted that fictitious profits, or credits, "earned" during an investor's involvement in a Ponzi and pyramid scheme are not components that should be considered in determining the amount of a participant's claim. *See In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d 229, 241-42 (2d Cir. 2011); *Donell v. Kowell*, 533 F.3d 762, 772 (9th Cir. 2008); *SIPC v. BLMIS*, 499 B.R. 416, 424-29 (S.D.N.Y. 2013) ("*BLMIS I*"); *compare In re Churchill Mortgage Inv. Corp.*, 256 B.R. 664, 682 (Bankr. S.D.N.Y. 2000); *In re First Commercial Mgmt Grp.*, 279 B.R. 230, 232 (Bankr. N.D. Ill. 2002); *with In re Bayou Grp.*, 362 B.R. 624, 637-38 (Bankr. S.D.N.Y. 2007) ("*Bayou I*"); *In re Randy*, 189 B.R. 425, 441 (Bankr. N.D. Ill. 1995); *In re Int'l Loan Network, Inc.*, 160 B.R. 1, 12 (Bankr. D.D.C. 1993); *see also Janvey v. Golf Channel, Inc.* 780 F.3d 641 (5th Cir. 2015) (vacated and certified to the Supreme Court of Texas on this issue, *Janvey v. Golf Channel, Inc.*, 792 F.3d 539 (5th Cir. 2015), *certified question accepted* (July 17, 2015)); *Janvey v. Alguire*, 2013 WL 2451738 at *9 (N.D. Tex. Jan. 22, 2013); *SEC v. Bernard L. Madoff Investment Securities, LLC (In re Madoff)*, 522 B.R. 41, 47 (Bankr. S.D.N.Y. 2014) ("*BLMIS II*"); *In re Taubman*, 160 B.R. 964, 980 (Bankr. S.D. Ohio 1993); *In re Bayou Grp., LLC*, 439 B.R. 284, 309 (S.D.N.Y. 2010) ("*Bayou II*"). Recovery based upon such amounts may be prejudicial to other investors in the scheme. *BLMIS I* at 427-29; *BLMIS II* at 47; *Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995).

In the present cases, the accumulated credits issued to Participants for activities such as posting advertisements are equivalent to the fictitious profits promised in Ponzi schemes. The Participants were guaranteed an astronomical return by merely purchasing a membership plan

and posting internet advertisements reportedly supplied by the Debtors. Participants were not required to sell a product to receive payment. Accordingly, claims based on the accumulated credits for the posting of advertisements should be disallowed. *See BLMIS I* at 427-29; *BLMIS II* at 47; *Scholes* 56 F.3d at 757; *M & L Bus. Mach. Co.*, 84 F.3d 1330, 1341 (10th Cir. 1996).

The accumulated credits based on the recruitment of later Participants should also be disallowed because the recruitment activity only contributed to and perpetuated the Debtors' scheme and provided no value to the Debtors' estates. 11 U.S.C. § 502(b)(1); *See In re Vaughan Co. Realtors*, 500 B.R. 778, 794 (Bankr. D.N.M. 2013); *Warfield v. Byron*, 436 F.3d 551, 560 (5th Cir. 2006); *In re Taubman*, 160 B.R. at 980; *Janvey*, 2013 WL 2451738 at *9; *Randy*, 189 B.R. at 441; *In re Independent Clearing House Co.*, 77 B.R. 843, 857 (Bankr. D. Utah 1987). Because the Debtors received no value for the accumulated credits, claims based on such credits should be disallowed. *See 11 U.S.C. §502(b)(1); Independent Clearing House*, 77 B.R. at 857; *Warfield*, 436 F.3d at 560; *Johnson v. Home State Bank*, 501 U.S. 78, 86 (1991); *In re Muller*, 479 B.R. 508, 515 (Bankr. W.D. Ark. 2012).

Recognizing claims based on the accumulated credits would result in favoring Participants who were involved early in the scheme over those that invested later, since the earlier Participants had more time to accumulate credits. *See Abrams v. Eby (In re Young)*, 294 F. 1, 4 (4th Cir. 1923) (recognizing that allowing a claim for both false profits and the original investment would not be equitable as profits had come at the expense of innocent investors). The Court should therefore disallow the claims based on the accumulated credits under its equitable powers. *Id.*; *see also Official Cattle Contract Holders Comm. v. Commons (In re Tedlock Cattle Co.)*, 552 F.2d 1351, 1353 (9th Cir. 1977).

To date, no objection has been filed to the proposed disallowance of credits in the determination of the amount of Participant claims.

II. The amount of claims should be determined on a Net Equity basis taking into consideration the Triangular Transactions.

The Ponzi Motion seeks approval of the use of the Net Equity method in determining the amount of Participant claims in these cases.[3] The Net Equity calculation is as follows: the amount invested by a Participant into the Debtors, including amounts paid by the Participant pursuant to the Triangular Transactions, less amounts received by a Participant from the Debtors' scheme, including amounts received by the Participant pursuant to the Triangular Transactions.

In resolving claims and distribution issues in Ponzi and pyramid scheme cases, equitable considerations need to be taken into account to properly address the harms suffered by participants in the scheme. *See Cunningham v. Brown*, 265 U.S. 1, 13, 44 S. Ct. 424, 427, 68 L. Ed. 873 (1924) (all investors in a Ponzi scheme must be treated equally and that "equality is equity and this is the spirit of the bankrupt law"); *In re Young*, 294 F. at 4; *In re Taubman*, 160 B.R. at 980; *Int'l Loan Network*, 160 B.R. at 14; *BLMIS II* at 47. In order to fashion an equitable result, claims in such cases are determined upon a net equity basis, that is, the claim amount is equal to amounts that an investor paid into the scheme, reduced by amounts an investor received from the scheme. *See, e.g., CFTC v. Topworth Int'l Ltd.*, 205 F.3d 1107, 1115-16 (9th Cir. 2000); *In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d at 242; *Donell*, 533 F.3d at 772; *In re Tedlock Cattle Co.*, 552 F.2d at 1353; *In re Young*, 294 F. at 4; *BLMIS I* at 427-29; *Janvey*, 2013 WL 2451738 at *9; *Bayou II at* 309; *BLMIS II* at 47; *In re Old Naples Sec., Inc.*, 311 B.R. 607,

[3] The calculation of the amount of a Participant's claim using the Net Equity method is without prejudice to the Trustee's right to object to the claim of a Participant who may have had knowledge that the Debtors were engaging in a fraudulent scheme and is therefore not entitled to the claims afforded innocent Participants;

616-17 (M.D. Fla. 2002). The Direct Transactions should therefore comprise one component of the Net Equity methodology but, as described below, those transactions should not be the only component included in the calculation of the amount of Participant claims.

The Debtor's scheme has elements of both a Ponzi scheme and a pyramid scheme. It is a Ponzi scheme in that Participants were guaranteed an exorbitant return on their initial investment, without the need to sell any product, which was funded from the fees paid by later Participants (since the Debtors had no legitimate business operations or earnings). *See e.g. In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 8 (S.D.N.Y. 2007); *Eberhard v. Marcu*, 530 F.3d 122, 132 (2d Cir. 2008); *accord In re Bernard L. Madoff Inv. Secs. LLC*, 654 F.3d at 232. It is a pyramid scheme in that Participants had the right to receive commissions for recruiting Participants and to retain membership fees paid by those Participants to them by using accumulated credits to satisfy the recruited Participant's invoice. *See e.g. Whole Living, Inc. v. Tolman*, 344 F. Supp. 2d 739, 745 (D. Utah 2004). The Debtors created an artificial currency in the form of credits. The principal vehicle for monetizing those credits was through the recruitment of Participants and the implementation of Triangular Transactions. After examining the nature and mechanics of the Debtors' Ponzi scheme, and the prevalent use of the Triangular Transactions, the Trustee has determined that in order to achieve an equitable result, the payments made and received in Triangular Transactions should be included in the Net Equity calculation. Specifically, the recruited Participant should have a claim recognized in the bankruptcy cases for the amounts advanced to a recruiting Participant in a Triangular Transaction, and the recruiting Participant should have their claim reduced for amounts paid to them by the recruited Participant.

This result is necessary to avoid an inequitable outcome. The inequities that would result if Triangular Transactions are not included in the calculation of the amount of a Participant's claim are substantial. First, the Participant at the bottom of the Triangular Transaction would be denied a claim for amounts paid to another Participant to purchase a membership plan from the Debtors. Second, the Participant who received amounts from another Participant through a Triangular Transaction would have an opportunity to profit further by having their claim amount not reduced on account of such payment. The overarching inequity that the net equity method seeks to rectify is that between net winners and net losers. The implementation of the Net Equity method including both Direct Transactions and Triangular Transactions achieves that result. [4]

A trustee's determination of an appropriate formula to calculate a participant's claim in a Ponzi scheme should be accorded a degree of deference provided that the method chosen by the trustee allocates net equity among competing claimants in a manner not clearly inferior to other proposed methods. *See In re Bernard L. Madoff Inv. Secs. LLC*, 654 F.3d at 232. The Trustee's rationale for using the Net Equity method for both Direct Transactions and Triangular Transactions is well supported and promotes the equitable treatment of all Participants.

The sole objection filed to date to the adoption of the Net Equity methodology was by the PIEC, whereby the PIEC objected to the inclusion of the Triangular Transactions in the Net Equity calculation of a Participant's claims. As discussed above, the failure to include Triangular Transactions would skew the results. Net losers would have no claim, and net winners would further profit from the scheme. Apparently recognizing these inequities, the

[4] Recognizing the Triangular Transactions in the calculation of Net Equity of a Participant who used accumulated credits to purchase new membership plans for himself/herself through multiple User Accounts achieves a fair result as well. No cash was exchanged through these intra-Participant transactions, and the Participant's claim for the purchase of a membership plan in one User Account will be offset by a reduced claim for the other User Account.

PIEC modified its blanket opposition to the inclusion of Triangular Transactions in the Net Equity calculation for purposes of claim determination. At the December 11, 2015 hearing before the District Court on the Trustee's *Motion to Intervene* to oppose the proposed third amended complaint whereby the PIEC sought to bring a class action against a subset of net winners, the PIEC stated as follows:

> The Trustee has also filed in the bankruptcy case a – a series of motions, the Ponzi scheme being one of them, the bar date motion being another, seeking to have the bankruptcy judge issue some guidance as to how proofs of claim are going to be filed in the bankruptcy case and the mechanisms that should guide the parties as to the allowance of those claims. We've not opposed those.
> ...
> Secondly, we do not oppose in the bankruptcy case the calculation that the trustee would use or the – I'm sorry – that the Bankruptcy Court would set for the determination of what is an allowable claim and what is not an allowable claim in the bankruptcy cases. We do not oppose that.
> *Transcript of hearing on Motion to Intervene, at p. 16:1-9; p. 16:19-23.*

While recognizing that the Triangular Transactions should be included in Net Equity for the calculation of claims, the PIEC argued before the District Court that the Triangular Transactions do not involve the Estates or property of the Estates. Therefore, the PIEC asserted that it should be allowed to amend its complaint for the third time to include claims for unjust enrichment based upon the Triangular Transactions. The Trustee argued that the PIEC's position was wrong because the Triangular Transactions involved property of the Estates and the PIEC action would, among other things, constitute a violation of the automatic stay. On December 11, 2015, after a hearing, the District allowed the Trustee's *Motion to Intervene* and on January 15, 2016, the District Court denied the PIEC's motion to amend its existing complaint to add a proposed class action.

The PIEC's assertion that the Estates had no interest or involvement in the Triangular Transactions ignores the substance of the Triangular Transaction and the Debtors' essential role

therein. The recruited Participant purchased a membership plan from the Debtors, and the Debtors sent an invoice to the recruited Participant. The recruited Participant paid the membership fee to the recruiting Participant in exchange for the Debtors issuing a membership plan to the recruited Participant, with the promised guaranteed return for placement of advertisements. The Debtors permitted the recruiting Participant to retain the membership fee and to utilize his/her accumulated credits to satisfy the invoice due from the recruited Participant. If the Debtors had no interest in the funds, there would have been no basis to reduce the recruiting Participant's accumulated credits. Simply put, the Triangular Transactions would not have occurred without the Debtors' extensive involvement.

The substance of a transaction should prevail over its form when determining how the transaction relates to the rights of parties in a bankruptcy case. *See, e.g., In re PCH Assocs.*, 949 F.2d 585, 597 (2d Cir. 1991) (*citing Pepper v. Litton*, 308 U.S. 295, 304 (1939)); *In re Adelphia Communications Corp.*, 512 B.R. 447 (Bankr. S.D.N.Y. 2014)(series of transactions may be treated as single transaction when it appears that, despite formal structure erected and labels attached, the segments comprise a single integrated scheme when considering knowledge and intent of parties involved in transaction). A review of the substantive nature of the Triangular Transactions compels the conclusion that such transactions involved transfers of property of the bankruptcy estates.

The collapsing of transactions into an integrated transaction has been employed by the courts in varying contexts to reflect the substantive nature of a series of related transactions. In the case of leveraged buyouts, payments made by an acquirer to selling shareholders are considered to be transfers of estate property even though the funds were paid by the stock purchaser and not the debtor. *See, e.g, In re Chas P. Young Company*, 145 B.R. 131 (Bankr.

S.D.N.Y. 1992); *In re OODC, LLC,* 321 B.R. 128 (Bankr. D. Del. 2005); *United States v. Tabor Court*, 803 F.2d 1288 (3rd Cir. 1986) (*cert. den. McClellan Realty Co. v. United States*, 483 U.S. 1005 (1987)); *Wieboldt Stores v. Schottenstein*, 94 B.R. 488 (N.D. Ill. 1988); *In re O'Day Corporation*, 126 B.R. 370 (Bankr. D. Mass. 1991); *In re Jevic Holding Corp.*, 2011 WL 4345204 (Bankr. D. Del. Sept. 15, 2011). Similarly, payments made by a purchaser of a debtor's assets to certain of the debtor's creditors are considered to be transfers of estate property even though the funds were paid by the asset purchaser and not the debtor. *See, e.g., Warsco v. Preferred Technical Group*, 258 F.3d 557, 568-69 (7th Cir. 2001); *In re Food Catering & Housing, Inc.,* 971 F.2d 396 (9th Cir. 1992).

The same rationale applies for collapsing the components of the Triangular Transaction to reflect the economic realities of the Debtors' scheme. In effect, the recruited Participant paid the Debtors for the purchase of a membership plan or VoIP Package. The Debtors, in turn, distributed the invoice amount to the recruiting Participant in exchange for a reduction in the recruiting Participant's accumulated credits. Attached as Exhibit "B" is a schematic of the Triangular Transaction as it occurred; Exhibit "C" is a schematic of the Triangular Transaction after it has been characterized to reflect the economic substance of the transaction. The Net Equity formulation recognizes the claim of the paying Participant in the Triangular Transaction even though the funds were not directly received by the Debtors. The Debtors became obligated to the recruited Participant under the membership plan and issued credits and payments to that Participant. The PIEC acknowledges that the recruited Participant should have a claim against the Estates, a result which can only be justified if the payment made by the recruited Participant is considered a payment into the Debtors that is appropriately included under the classic Ponzi claim formulation.

The PIEC argues that the Triangular Transactions should not be collapsed because the Debtors were operating a Ponzi and pyramid scheme and the Debtors had no right to recover the funds paid to the recruiting Participant. Contrary to the PIEC's argument, it is well established that transfers to a participant are not insulated from recovery because the debtors operated a Ponzi scheme. *See, e.g., In re Ramirez Rodriguez*, 209 B.R. 424 (Bankr. S.D. Tex. 1997); *In re Universal Clearing House Co.*, 62 B.R. 118 (D. Utah 1986); *In re Hedged-Investments Assoc., Inc.*, 163 B.R. 841, 850-51 (Bankr. D. Colo. 1994), *aff'd* 84 F.3d 1286 (10th Cir. 1996); *In re Int'l Loan Network*, 160 B.R. at 11; *In re Taubman*, 160 B.R. at 980; *In re Baker & Getty Financial Services, Inc.*, 98 B.R. 300 (Bankr. N.D. Ohio 1989); *In re Geltzer*, 502 B.R. 760 (Bankr. S.D.N.Y. 2013). In order to promote a fair and equitable distribution to Participants, the Trustee needs to bring recovery actions against the recruiting Participants who were net winners from their involvement in the scheme.[5]

III. There is no need for an adversary proceeding to determine the relief sought in the Ponzi Motion.

The Trustee filed the Ponzi Motion and the Notice Motion on October 7, 2015. No objections were filed to the Notice Motion or the scheduling of a hearing on the Ponzi Motion. On October 14, 2015, the Court approved the Notice Motion and scheduled the Ponzi Motion for evidentiary hearing on November 24, 2015. On or about October 19, 2015, the Ponzi Motion and related notice of evidentiary hearing were served either electronically or by regular mail (if an electronic mail address was not available) upon all known Participants based upon information contained in (i) the Debtors' books and records, (ii) approximately 60,000 proofs of claim that had been filed through September 30, 2015; and (iii) approximately 10,000 victim

[5] On January 15, 2016, the Trustee commenced two class action proceedings against net winners in the Debtors' Ponzi scheme, one action against net winners residing in the United States (A.P. no. 16-4006) and one against net winners residing outside of the United States (A.P. no. 16-4007).

notification forms filed with the Federal Bureau of Investigation through September 30, 2015. A copy of the Ponzi Motion was posted on the website operated by the Trustee's claims agent, Kurtzman Carson Consultants ("KCC"), in English immediately after it was filed. Spanish and Portuguese translations of the Ponzi Motion were posted on KCC's website on or about October 24, 2015.

At the conclusion of the evidentiary hearing, the Court directed the Trustee to provide supplemental notice of the remaining relief sought in the Ponzi Motion. The Trustee filed and served a supplemental notice detailing the additional relief respecting the use of the Net Equity method to determine claim amounts and the continued hearing date. The supplemental notice was served on or about December 7, 2015 in the same manner as the initial Ponzi Motion notice, as set forth in the preceding paragraph.

At this point, all parties-in-interest have been notified, twice, over a period of approximately 90 days, of the Ponzi Motion and the relief sought. Given the extent of notice already provided, no point would be served, and no notions of due process would be furthered, by requiring the Trustee to start again and institute an adversary proceeding for the balance of the relief sought, including providing notice yet again to Participants. An adversary proceeding would burden the Estates with substantial costs and delays and prevent the timely rollout of the electronic proof of claim ("ePOC") and claims filing and determination process. The design of the ePOC and the web portal require that there be a determination of the components of Participants' claims. For example, if credits are to be excluded from the computation of claim amounts, the ePOC and web portal need not contain or disclose this data. Similarly, if Triangular Transactions were to be excluded as components of a claim, this data would be unnecessary. Otherwise, the ePOC would serve as little more than a data dump, and the cost to

the Estates of having to sift through countless claims lacking any uniformity, and to potentially having to object afterwards to tens or hundreds of thousands of proofs of claim, would be a poor use of the Estates' limited resources. Both the Ponzi Motion and Bar Date Motion are scheduled for hearing on January 26, 2016 and are ripe for adjudication.

To require an adversary proceeding to obtain the relief requested in the Ponzi Motion, as suggested by the PIEC, would truly be an elevation of form over substance. All interested parties have had adequate notice of the requested relief, an opportunity to register objections and the right to be heard. The relief sought and the basis for such relief have been clearly articulated. There are no material facts in dispute. The relief is amply supported by the evidence, and the Trustee has provided evidentiary support for the Ponzi Motion.[6]

Under these circumstances, there is no need for an adversary proceeding, as there is no substantive difference in the process afforded. *See In re Reitter Corporation*, 449 B.R. 641 (Bankr. D. Puerto Rico 2011); *In re Sameer Lakhany*, 538 B.R. 555 (9th Cir. BAP 2015); *In re Ballard*, 502 B.R. 311 (Bankr. S.D. Ohio 2013); *In re Vance*, 120 B.R. 181, 192 (Bankr. N.D. Okla. 1990). In other Ponzi scheme bankruptcy cases, the Net Equity determination has been sought and obtained by motion. *See, e.g., BLMIS I*, 424-29; *In re Pearlman*, 484 B.R. 241 (Bankr. M.D. Fla. 2012).

Based upon the foregoing and the Ponzi Motion, the Trustee requests that the Court enter the order attached as Exhibit "A" hereto and that the Trustee be granted such other relief as is appropriate.

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[6] The PIEC also argued that a determination of the methodology for claims allowance is procedurally premature. This assertion is similarly without merit. The Court has the authority to make rulings in advance that will streamline or facilitate the claims filing and resolution process. *In re Young*, 294 F. at 4. This is particularly so in cases involving a complex Ponzi and pyramid scheme with as many as 1,900,000 Participants.

STEPHEN B. DARR,
CHAPTER 11 TRUSTEE,

By his attorneys,

/s/ Harold B. Murphy

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Dated: January 19, 2016
701624

EXHIBIT A

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS
CENTRAL DIVISION

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

[PROPOSED] SUPPLEMENTAL ORDER RESPECTING MOTION BY CHAPTER 11 TRUSTEE FOR ENTRY OF ORDER FINDING THAT DEBTORS ENGAGED IN PONZI AND PYRAMID SCHEME AND RELATED RELIEF

PROCEDURAL BACKGROUND

1. On October 7, 2015, Stephen B. Darr, the duly appointed Chapter 11 trustee (the "Trustee") of the bankruptcy estates (the "Estates") of TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc. (collectively, the "Debtors") filed a *Motion for Entry of an Order Finding that the Debtors Engaged in a Ponzi and Pyramid Scheme and Related Relief* (the "Ponzi Motion") and a *Motion by Chapter 11 Trustee for Approval of Method of Service of Motion by Chapter 11 Trustee for Entry of Order Finding that Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief* (the "Notice Motion").

2. On October 14, 2015, the Court approved the Notice Motion, prescribing service of the Ponzi Motion, and scheduled an evidentiary hearing for November 24, 2015. The Trustee served the Ponzi Motion and hearing notice in compliance with the order approving the Notice Motion on or about October 19, 2015.

3. After conducting the evidentiary hearing, the Court made partial rulings on the Ponzi Motion by order dated November 25, 2015, as amended on December 21, 2015. The

Court then scheduled a continued hearing on the Ponzi Motion for January 26, 2016 to consider the balance of the relief sought. The Court directed that the Trustee provide supplemental notice of the Ponzi Motion and continued hearing notice to parties-in-interest.

4. The Trustee provided supplemental notice to Participants of the continued hearing and the additional relief sought on or about December 7, 2015. On or about such date, the Trustee filed a copy of the supplemental notice of the Ponzi Motion and filed a certificate of service.

ORDER

5. The Court, having conducted the continued hearing on the Ponzi Motion, upon the evidence submitted and the arguments of counsel made at the hearings, and the Court having reviewed all documents in connection with the Ponzi Motion, including the *Affidavit of Stephen B. Darr in support of Motion by Chapter 11 Trustee for Entry of Order Finding that Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief* ("Darr Affidavit"), and notice of the Ponzi Motion having been given to all parties in interest in accordance with the order dated October 14, 2015; and supplemental notice of the Ponzi Motion and continued hearing having been given on or about December 7, 2015; and the Court having considered the oppositions filed, notice of the Ponzi Motion being sufficient; and after due deliberation and consideration of all of the foregoing, and sufficient cause appearing therefor, the Court hereby orders that:

(i) In determining the amount of claims of Participants,[1] any claim or portion of claim based upon accumulated credits in a Participants' User Accounts as of the Petition Date shall be disallowed;

[1] All terms not otherwise defined herein shall have the meaning ascribed to them in the Ponzi Motion.

(ii) The payment made by a recruited Participant to a recruiting Participant in a Triangular Transaction is a transfer of property of the Debtors' Estates, and should be included in the calculation of Net Equity;

(iii) The claims amounts of Participants shall be determined on a Net Equity basis, which shall be defined as follows: the amount invested by the Participant into the Debtors' scheme, including amounts paid pursuant to Triangular Transactions, less amounts received by the Participant from the Debtors' scheme, including amounts received pursuant to Triangular Transactions.

(iv) In determining the amount of a claim of a Participant who has more than one User Account, the activity in all of the Participants' User Accounts shall be aggregated and netted against one another;

(v) The calculation of a Participant's claim using the Net Equity basis is without prejudice to the Trustee's right to object to the claim of a Participant who had knowledge that the Debtors were engaging in a fraudulent scheme and is therefore not entitled to the claims afforded innocent Participants;

(vi) The relief granted herein is appropriately made by motion and does not require the institution of an adversary proceeding; and

(vii) The foregoing findings and conclusions shall be applicable for all purposes in these proceedings.

Dated: _____, 2016
695605

_____
Honorable Melvin S. Hoffman
Chief United States Bankruptcy Judge

EXHIBIT B

STRUCTURE OF TRIANGULAR TRANSACTION

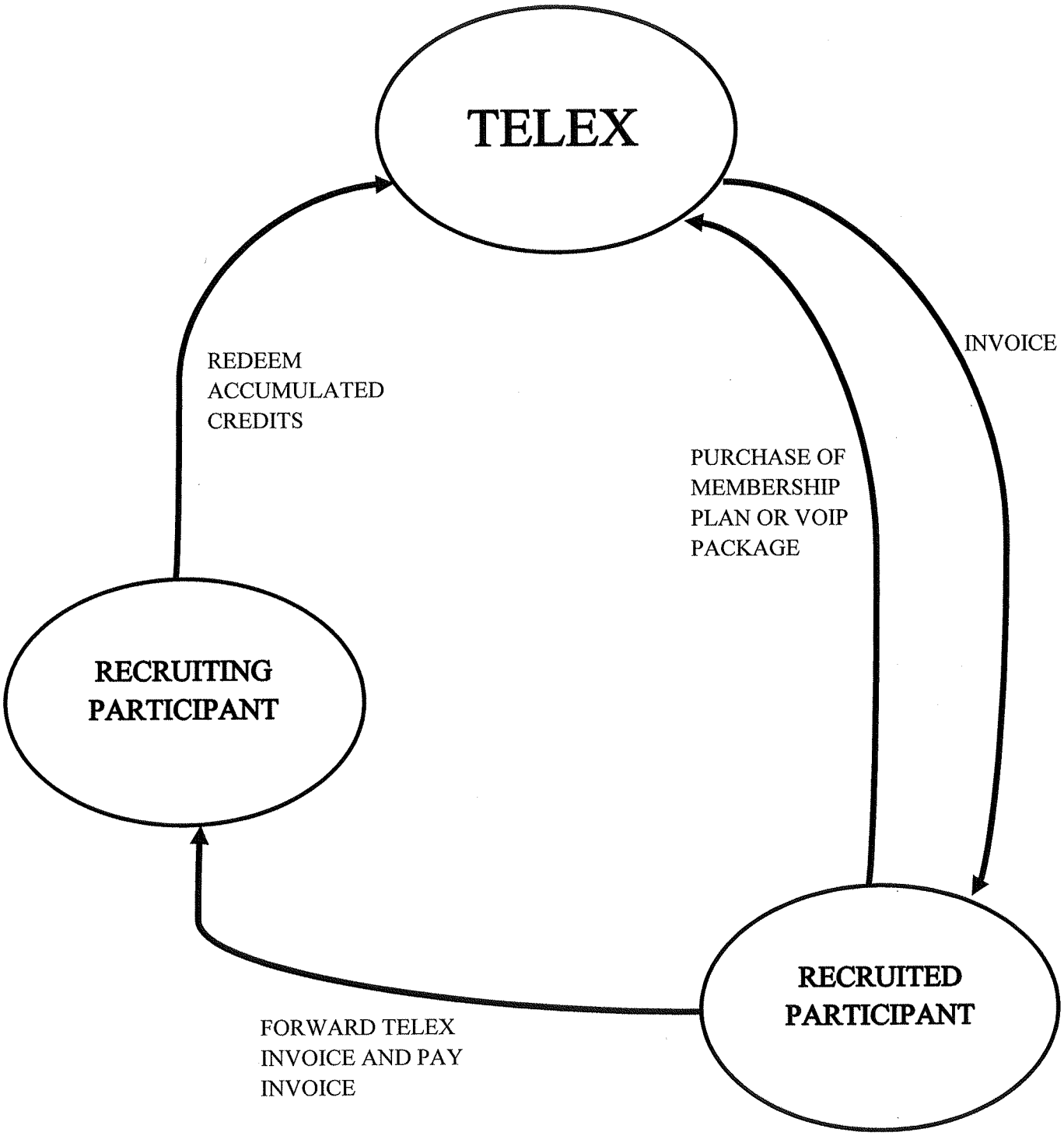


EXHIBIT C

SUBSTANTIVE CHARACTERIZATION OF TRIANGULAR TRANSACTION

