Docket #0068 Date Filed: 11/4/2019

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS

In re: TELEXFREE, LLC, TELEXFREE, INC. and TELEXFREE FINANCIAL, INC., Debtors.	Chapter 11 Cases 14-40987-MSH 14-40988-MSH 14-40989-MSH Jointly Administered
STEPHEN DARR, AS HE IS THE TRUSTEE OF THE CHAPTER 11 ESTATES OF EACH OF THE DEBTORS, Plaintiff, v. UNITED STATES OF AMERICA, DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, Defendant.	Adversary Proceeding No. 18-4091

AFFIDAVIT OF STEPHEN DARR AS HE IS THE CHAPTER 11 TRUSTEE OF THE DEBTORS IN SUPPORT OF THE OPPOSITION TO THE UNITED STATES OF AMERICA'S SECOND MOTION FOR PARTIAL FOR SUMMARY JUDGMENT

I, Stephen Darr, in my capacity as the Trustee of the Chapter 11 Bankruptcy Estates of TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc. (collectively "TelexFree"), am making this affidavit in support of the Opposition to the United States of America's Second Motion for Partial Summary Judgment based upon my personal knowledge gained in administering the TelexFree proceeding and my investigation of TelexFree's business, with the assistance of Huron Consulting Services, LLC, my financial advisors, and being duly sworn depose and state as follows:

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1. Ostensibly, TelexFree operated as a multi-level marketing ("MLM") company engaged in the business of selling a voice over internet protocol service, or "VoIP" for a monthly charge of $49.90 to conduct international phone calls.

2. However, revenues from the sale of VoIP plans constituted less than one percent of total revenues and in fact TelexFree operated a Ponzi and pyramid scheme using an MLM structure to sell membership plans.

3. Ponzi schemes and pyramid schemes require a constant flow of new capital to continue operating. Accordingly, TelexFree devised a system to incentivize Participants to join TelexFree, to purchase membership plans, and to recruit others to join TelexFree and purchase membership plans. Because of the incentives, TelexFree grew exponentially, generating more than $3,000,000,000 in revenues in less than three years.

4. At the time this adversary proceeding was commenced, TelexFree's recorded net worth was less than $7,000,000 (and it was insolvent after consideration of the liabilities or "credits" incurred at that date). It employed less than 500 people.

5. The Participants were referred to as promoters in their contract with TelexFree.

6. The TelexFree contract specified how Participants could earn credits.

7. Once a membership plan was purchased, Participants could earn credits for promoting TelexFree's business by posting internet advertisements and for recruiting other Participants (the "Promotional Expenses").

8. Each time that a Participant purchased a membership plan or VoIP package, an account ("User Account") was established with SIG, TelexFree's computerized recordkeeping system. During the operation of the TelexFree business, more than 1,000,000 Participants opened more than 11,000,000 User Accounts.

9. After a User Account was established, SIG tracked the activity of the Participant in that User Account, including the accumulation of credits for promotional activities on behalf of TelexFree, the use of credits, and payments made to or from a Participant directly with TelexFree.

10. Credits earned for promotional activities could be redeemed for cash or applied in satisfaction of an invoice for the purchase of a membership plan.

11. A Participant could monetize his/her accumulated credits by recruiting a new Participant to join TelexFree and using his/her accumulated credits to satisfy the invoice for the new Participant's membership plan in exchange for payment of the membership fee from the new Participant ("Triangular Transaction"). In a Triangular Transaction, TelexFree issued the membership invoice that was due to TelexFree to the recruited Participant, the recruited Participant paid the TelexFree membership invoice to the recruiting Participant, and TelexFree redeemed the credits of the recruiting Participant in satisfaction of the invoice.

12. Based upon the SIG records, the following chart accurately reflects the amount of credits issued to Participants and redeemed by Participants for 2012, 2013, and 2014:

	Credits Issued and Redeemed			
Year	**Issued**	**Redeemed for Membership Plan**	**Redeemed for Cash**	**Total Redeemed**
2012	$ 4,261,846	$ 3,407,954	$ 853,892	$ 4,261,846
2013	$ 972,955,648	$ 843,475,755	$ 68,144,795	$ 911,620,550
2014	$2,442,705,606	$1,866,795,376	$ 83,212,109	$1,950,007,485

13. TelexFree operated its business on a full-time basis.

14. TelexFree retained full-time employees, rented office space in Marlborough, Massachusetts, contracted with vendors in the ordinary course of business, and entered into contracts with Participants.

15. TelexFree reported income in each year of its operation and reported a profit in 2012.

16. Participants earned credits for promotional activities by logging onto TelexFree's website to download marketing materials, posting advertisements on the chosen websites, and returning to TelexFree's website to validate their posting of the advertisements, and by recruiting others to do so.

17. TelexFree incurred a liability when it issued credits to Participants for posting advertisements on the internet in order to keep the TelexFree name before the public, to promote the goodwill of TelexFree, and to enlist new Participants. The advertising ensured TelexFree's name was frequently at the top of a listing of several MLM or business opportunities shown.

18. TelexFree was almost exclusively an internet-based operation. TelexFree and its Participants promoted the business extensively using an online presence including internet advertisements, social media, and internet videos. Marketing meetings were also held to promote the business.

19. Participants were separately incentivized to recruit others into TelexFree through the issuance of credits for selling memberships.

20. TelexFree encouraged Participants to recruit new Participants into the business.

21. The promise of substantial returns was an essential element of the TelexFree business model. These credits were only to be issued upon the completion of the promotional activity. The right to earn credits for promoting TelexFree business was a primary inducement for Participants to join the TelexFree business.

22. The Promotional Expense for advertising and selling membership plans represented a fixed and unconditional amount due to the Participant under the terms of his or her membership contract with TelexFree.

23. In the context of TelexFree's business, the Promotional Expenses were ordinary and necessary to the operation and expansion of the TelexFree business.

24. The amount of the Promotional Expenses represented a fixed and unconditional amount due to the Participant under the terms of his or her membership plan.

25. The Promotional Expenses incurred by TelexFree were normal, usual, and customary expenses associated with the development and operation of a Ponzi and Pyramid scheme.

26. In the context of TelexFree's business, the Promotional Expenses were reasonable in amount and bore a reasonable relationship to the business of operating the TelexFree business.

27. The Promotional Expenses deducted on TelexFree's 2012 Amended Return, 2013 Amended Return, and 2014 Amended Return are substantiated by the books and records of TelexFree, including SIG.

28. The Promotional Expenses were regularly redeemed by Participants until shortly before the Petition Date, both for cash and in satisfaction of membership fees due in connection with the purchase of membership plans in triangular transactions.

29. The amount of Promotional Expenses redeemed by Participants approximated the amount of credits issued in each year.

30. Participants did not acquire an equity interest in TelexFree by entering into a membership contract with TelexFree.

31. The Participants had no vote or input into management of TelexFree.

32. The Participants were not employees of TelexFree. IRS Form 1099's were issued to Participants in the United States for the year ended 2013.

33. Ympactus operated in Brazil with a business model similar to the model employed by TelexFree.

34. TelexFree provided accounting and administrative services to Ympactus in 2012 and 2013.

35. In the 2012 Return and the 2012 Amended Return, TelexFree LLC and I as Trustee, respectively, reported income from Ympactus in the amount of $11,869,444 as a charge to Ympactus for accounting and administrative services provided by TelexFree to Ympactus.

36. In the 2013 Return and 2013 Amended Return, I on behalf of TelexFree LLC reported income from Ympactus in the amount of $174,183,645 as a charge to Ympactus for accounting and administrative services provided by TelexFree to Ympactus.

37. In 2013, the Brazilian authorities seized all of Ympactus' assets and its operations ceased, and its obligations to TelexFree became uncollectible.

38. In both the 2013 Return and 2013 Amended Return, TelexFree LLC and I as Trustee recognized the uncollectibility of the unpaid amounts due from Ympactus in the amount of $186,344,898 because of the Brazilian authorities seizure of Ympactus' operations and all of its assets that year.

39. The Service's disallowance of the Ympactus bad debt deduction without any offsetting adjustment to the reported Ympactus income is fundamentally inconsistent with a fair presentation of TelexFree's taxable income or loss.

40. On April 15, 2014, federal agents executed three search warrants at TelexFree

headquarters in Marlborough, Massachusetts. During that search, federal officers seized TelexFree's property including but not limited to cashiers' checks totaling approximately $38,000,000. Subsequently, the U.S. Attorney's Office for the District of Massachusetts executed 37 additional seizure warrants. The United States ultimately seized in excess of $148,000,000 in cash and real personal property in proceeds from the operation of the TelexFree business (the "Funds").

41. No criminal fines or penalties have been imposed upon TelexFree.

42. I as Trustee have worked closely with the United States in connection with the recovery of funds to be paid as restitution for victims.

43. I as Trustee had notice of the Preliminary Order of Forfeiture and did not object or challenge the order of forfeiture with respect to the Funds and tangible property as part of an agreement with the United States that the Funds and tangible property, or proceeds thereof, would be turned over to me for payment as restitution to victims.

44. On July 11, 2017, in connection with the sentencing of James Merrill for his participation in TelexFree, the District Court entered an order authorizing me to establish a system to administer restitution claims and pay restitution to victims and ordered restitution to be paid to the victims of TelexFree by me as the Chapter 11 Trustee (the "Restitution Order").

45. The Restitution Order was premised upon the agreement between the United States and me as Trustee that the seized funds would be delivered to me to be administered by the Trustee as restitution for the benefit of the victims of the Ponzi scheme.

46. On or about June 15, 2019, the United States turned over to the Trustee the sum of $145,471,294 in connection with the Restitution Order.

47. The action by the United States Trustee in seizing property of TelexFree or property derived from or constituting proceeds traceable to the business of TelexFree is a loss of property (the "Loss") for TelexFree.

48. TelexFree was not insured for the Loss nor otherwise compensated for the Loss.

49. The Trustee has displaced the Debtors' management, and operations have been shut down. The Trustee was appointed to liquidate the Debtors' assets and to pursue recoveries.

50. I have responded to all requests for information made by the Service and I have appeared for a deposition in this adversary proceeding.

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Signed under the pains and penalties of perjury this 4th *day of November 2019.*

Stephen Darr

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Tracy A. Genzale
Notary Public
Commonwealth of Massachusetts
My Commission Expires on April 3, 2020