

E-Filed: April 22, 2014

Scott Andrew Farrow
Acting Assistant United States Trustee
State Bar No.: WI 1000609
scott.a.farrow@usdoj.gov

J. Michal Bloom, Trial Attorney
State Bar No.: NV 4706
j.michal.bloom@usdoj.gov

UNITED STATES DEPARTMENT OF JUSTICE

Office of the United States Trustee
300 Las Vegas Boulevard, So., Suite 4300
Las Vegas, Nevada 89101
Tel: (702) 388-6600
Fax: (702) 388-6658

Attorneys for the United States Trustee for Region 17
TRACY HOPE DAVIS

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEVADA

In re:

TELEXFREE, LLC,☐ AFFECTS THE DEBTOR☒ AFFECTS ALL DEBTORS☐ AFFECTS TELEXFREE, INC.☐ AFFECTS TELEXFREE FINANCIAL, INC.

CASE NO. BK-S-14-12524
Chapter 11

[PROPOSED]**Jointly Administered with:**

14-12525-abl Telexfree, Inc.
14-12526-abl Telexfree Financial, Inc.

Date: OST Pending
Time: OST Pending

MOTION OF THE UNITED STATES TRUSTEE FOR ORDER
DIRECTING THE APPOINTMENT OF
A CHAPTER 11 TRUSTEE PURSUANT TO §1104 (a)

To the Honorable August B. Landis, United States Bankruptcy Judge:

Tracy Hope Davis, United States Trustee for Region 17, hereby moves the Court for an Order Directing the Appointment of a Chapter 11 Trustee Pursuant to 11 U.S.C. § 1104(a) (the "Motion"). In support the United States Trustee represents and alleges as follows:



MEMORANDUM OF POINTS AND AUTHORITIES

I. PRELIMINARY STATEMENT

The appointment of a Chapter 11 trustee is required under the standards set forth in section 1104(a) of the Bankruptcy Code. There is compelling evidence of fraud, dishonesty and gross mismanagement of the affairs of the TelexFree debtor entities, TelexFree, LLC, TelexFree, Inc. and TelexFree Financial, Inc. (collectively, “TelexFree” or the “Debtors”). There are reasonable grounds to suspect that the members of the governing board who selected the Debtors’ new executives participated in actual fraud, dishonesty and criminal conduct in the management of TelexFree. The facts mandating the appointment of a trustee include:

- (1) allegations of securities fraud committed in the course of operating a billion dollar Ponzi scheme resulting in recent civil enforcement actions by the Securities and Exchange Commission (the “SEC”) and the Secretary of the Commonwealth of Massachusetts, Securities Division (the “MSD”);
- (2) allegations regarding very recent diversions of millions of dollars in cash for the personal benefit of the Debtors’ principals and officers.

Specifically, on April 15, 2014, the SEC filed a complaint (the “SEC Complaint”) and an Emergency *Ex Parte* Motion for a Temporary Restraining Order (“TRO”) in the United States District Court for the District of Massachusetts against TelexFree, LLC, TelexFree, Inc., James Merrill, Carlos Wanzeler and Joseph Craft, among others (collectively referred to as the “Defendants”). The SEC Complaint contains very specific and serious allegations based on the SEC’s finding that the Defendants were involved in an illegal pyramid scheme that has raised as much as \$1 billion dollars over the course of 18 months through a fraudulent and unregistered offering of securities to Brazilian and Dominican immigrants. According to the SEC, TelexFree is a Massachusetts based “multi-level marketing” company that purports to be in the business of selling international telephone service plans that use “voice over internet protocol” (“VoIP”)

1 technology. The securities take the form of “memberships” that promise substantial returns –
2 200% per year or more – for becoming promoters of the business. TelexFree promises to pay
3 promoters for: (a) placing duplicative TelexFree ads on internet sites – a process which, by
4 itself, generates no revenue; and (b) recruiting other investors who pay the membership fees that
5 constitute the lion’s share of TelexFree’s revenue.
6

7 TelexFree has been a money-making machine for the Defendants. The company’s
8 financial records indicate that, since mid-November 2013, TelexFree has transferred
9 approximately \$30 million from its operating accounts to its principals and officers (named
10 Defendants) and to affiliated companies. Millions of additional investor funds received by
11 TelexFree are presently unaccounted for. Fortunately, the TRO was granted by the District
12 Court for the District of Massachusetts and all of the Debtors’ accounts have been frozen
13 pending a preliminary injunction.
14

15 The Defendants are continuing to enroll new investors every day, but it is clear that the
16 pyramid has collapsed. In response to subpoenas issued by the MSD in January and February,
17 2014, TelexFree changed its compensation plan so that promoters would now be required to sell
18 its VoIP product in order to qualify for the payments that TelexFree had previously promised to
19 pay them. The rule change has generated a storm of protests from promoters who cannot
20 recover their money. The change has also caused a precipitous decline in investor revenue
21 which has pushed TelexFree into bankruptcy.
22

23 Merrill and Wanzeler, named defendants in the SEC action, each own 50% of TelexFree
24 and continue to be the sole members of the Board of Managers/Directors (the “Board”) for these
25 companies. Craft, recently appointed as “Acting CFO,” “Authorized Person,” and signatory on
26 all of the Debtors’ accounts, is also a named defendant and recipient of several million dollars
27
28

1 of diverted funds. Additionally, Craft was the incorporator of TelexFree Financial, Inc.
2 (a Florida corporation) on December 26, 2013.

3 Not only is there substantial cause here, but the appointment of a Chapter 11 trustee
4 would clearly be in the interests of the creditors of this estate. Given the pending civil actions
5 by the SEC and the MSD, coupled with impending promoter class actions for monetary
6 damages, it is an understatement that current management has lost the confidence of its
7 creditors and investors. For the Debtors' investors and creditors seeking financial
8 accountability, it is in their interests for an independent fiduciary to be appointed forthwith.
9

10 For these reasons, the United States Trustee urges the Court to grant the instant motion
11 and direct the United States Trustee to appoint a Chapter 11 trustee in accordance with Section
12 1104(a).
13

14 **II. BACKGROUND FACTS**

15 1. On April 13, 2014, the Debtors commenced these cases by filing voluntary
16 petitions under Chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (as
17 amended, the "Bankruptcy Code")¹. [Docket No. 1]. (*See also In re Telexfree, Inc.*, Case No.
18 14-12525 and *In re Telexfree Financial, Inc.*, Case No. 14-12526, each at Docket No. 1).
19

20 2. On April 13, 2014, Debtors filed a motion to jointly administer the Debtors'
21 cases with *In re Telexfree, LLC*, Case No. 14-12524 as the proposed lead case. [Docket No. 4].
22 At a hearing on April 17, 2014, the Court granted the motion for joint administration on an
23 interim basis and set a final hearing on the joint administration motion for May 2, 2014.
24 [Docket No. 46].
25

26
27
28 ¹ References to Sections are to sections of the Bankruptcy Code, unless otherwise noted.

1 3. On April 15, 2014, the SEC filed a complaint (the “SEC Complaint”) in the
2 United States District Court for the District of Massachusetts (*Securities and Exchange*
3 *Commission v. Telexfree, Inc. et al*, Case No. 1:14-cv-11858-DJC (the “SEC Case”), Docket No.
4 2) against the Debtors, their principals, and certain promoters, among others, alleging that they
5 have engaged in the operation of an illegal pyramid scheme and the fraudulent offer or sale of
6 unregistered securities. Contemporaneously with their complaint, the SEC filed an *Emergency*
7 *Ex Parte Motion for Temporary Restraining Order* [SEC Case, Docket No. 4] to restrain the
8 Debtors from further violations of the Securities Act, (15 U.S.C. § 77, *et seq.*) and to freeze all
9 of the Debtors’ assets and bank accounts. The motion for TRO was granted on April 16, 2014
10 [SEC Case, Docket No. 12] and the TRO was served on the Debtors on April 17, 2014. [SEC
11 Case, Docket No. 15].

12 4. On April 15, 2014, the MSD filed an administrative complaint (*In the Matter of*
13 *TelexFree, Inc & TelexFree, LLC (E-2014-0004)* (the “MA Case”)) against two of the three
14 Debtors, alleging that they engaged in the fraudulent offer or sale of unregistered securities in
15 violation of the Massachusetts Uniform Securities Act.

16 5. On April 15, 2014, Special Agents of the Department of Homeland Security,
17 Homeland Security Investigations (“HSI”) executed a search warrant on the Debtors’ corporate
18 offices at 225 Cedar Hill Street in Marlborough, Massachusetts. During the exercise of the
19 search warrant a Bristol County Deputy Sheriff encountered the Debtors’ new CFO, Joseph
20 Craft, entering an office and attempting to grab a laptop and bag. He stated that he was a
21 “consultant” helping TelexFree prepare for bankruptcy and that the laptop and bag were
22 “personal items.” HSI Agents searched the bag and identified ten Wells Fargo Bank cashier’s
23

1 checks totaling \$37,948,296.00. *See* Declaration of Scott R. Stanley, Esq. in Support of SEC
2 Motion for TRO (“Stanley Declaration.”). [SEC Case, Docket No. 7].

3 6. Debtors describe their company (TelexFree) as a telecommunications business
4 that uses multi-level marketing to assist in the distribution of voice over internet protocol
5 (“VoIP”) telephone services. TelexFree’s retail VoIP product, 99TelexFree, allows for
6 unlimited international calling to approximately 70 countries for a flat monthly fee of \$49.90.
7 They currently have over 700,000 “promoters” worldwide. *See* Omnibus Declaration of
8 William H. Runge (the “Runge Declaration”). [Docket No. 13].
9

10 7. The primary business of TelexFree, however, is not selling international phone
11 service at an affordable price. Rather, it is recruiting new investors (the “Promoters”) and
12 paying them to promote the company by placing internet advertisements and recruiting more
13 Promoters. As Merrill stated in a press release dated March 1, 2013:
14

15 In addition to providing an excellent service at a very reasonable price, the real
16 “secret sauce” of our success is our compensation plan. We have developed a
17 unique system which allows every one of our independent representative [sic]
18 the ability to make money every week. We actually pay our representatives
weekly if they follow our system and advertise our service on the Internet.

19 [See SEC Memorandum in Support of Motion for TRO (the “SEC Memorandum”), SEC Case,
20 Docket No. 4]. In fact, the Debtors’ “sauce” was so successful, that they took in approximately
21 \$1 billion in revenues in 2013, or approximately \$3 million in revenue *per day* pre-petition.
22 [See Runge Declaration, Docket No. 13, p. 10].
23

24 8. The Debtors’ current business was started in 2012 by James Merrill and Carlos
25 Wanzeler with the assistance of a Brazilian associate named Carlos Costa. The Debtors claim
26 that Costa set up a separate company in Brazil called Ympactus, also using their multi-level
27 marketing model. In June, 2013, the Brazilian authorities shut down Ympactus and froze its
28

1 assets, accusing it of operating a pyramid scheme. Investigations by federal and state authorities
2 in Brazil are continuing and numerous lawsuits against Ympactus by Brazilian Promoters have
3 been filed. [See Runge Declaration, Docket No. 13, p. 8].

4
5 9. After the enforcement action in Brazil, TelexFree began making public
6 statements to the effect that its business plan is different from illegal multi-level marketing
7 programs because it has an actual product to sell – the 99 TelexFree VoIP service. However,
8 the SEC’s ongoing investigation has revealed that only a small fraction of the Debtors’ revenue
9 is from the sale of VoIP contracts. See Declaration of Mark Albers (“Albers Declaration”).
10 [SEC Case, Docket No. 6]. The vast majority of TelexFree’s revenue has been received from its
11 Promoters. The disparity between TelexFree’s VoIP revenues and its obligations to its
12 Promoters grew and, like any classic pyramid scheme, TelexFree was forced to use money from
13 newer investors to make its payments to older investors. [SEC Memorandum, SEC Case,
14 Docket No. 4, pp. 17-19]. [See also Albers Declaration, SEC Case, Docket No. 6].

15
16
17 10. In response, the Debtors developed a “new” compensation plan for Promoters
18 making it much harder for them to qualify for payments. The new plan, which went into effect
19 March 10, 2014, was called the “Revised Comp Plan.” It has proven to be very unpopular with
20 Promoters because they actually have to sell the VoIP products in order to get paid. Not
21 surprisingly, the revenues generated under the new plan “have been disappointing” and do not
22 allow the Debtors to meet their obligations. [Runge Declaration, Docket No. 13, p. 9]. The
23 Debtors did not disclose that several banks and at least one payment processor stopped doing
24 business with them, apparently due to concerns about the legality of its multi-level marketing
25 program. [SEC Memorandum, SEC Case, Docket No. 4, pp. 17-19].
26
27
28

1 11. It appears that part of the reason for the Debtors' cash flow problems was the
2 diversion of funds to insiders. Mark Albers, a Forensic Accountant with the SEC in Boston,
3 was asked to review certain documents pertaining to the Debtors' bank and brokerage accounts,
4 federal wire transfer records and credit card payment processor records. During the course of
5 his review, he found evidence of the following transfers:
6

7 a. TelexFree Financial, Inc. received \$4,105,000.00 on December 30 and 31,
8 2013.

9 b. In December 2013, approximately \$14.3 million was transferred to newly
10 created brokerage accounts in the name of TelexFree LLC.

11 c. Merrill received \$3,136,200.00 on December 26 and December 27, 2013.

12 d. Wanzeler received \$7,317,800.00 on December 26 and December 27, 2013.

13 e. Two companies controlled by Craft received more than \$2,010,000.00
14 between November 19, 2013 and March 14, 2014.

15 f. Federal wire transfer records show that Wanzeler wired \$3.5 million to the
16 Oversea-Chinese Banking Corporation in Singapore on January 2, 2014.

17 [Albers Declaration, SEC Case, Docket No. 6].

18 12. When Craft was caught "holding the bag" during the execution of the HSI search
19 warrant on April 15, 2014, nine of the ten cashier's checks that were confiscated were dated
20 April 11, 2014 and were remitted to Merrill. Of these checks, five were made out to TelexFree,
21 LLC totaling \$25,548,809.00, and one was made out to Katia B. Wanzeler (Wanzeler's wife) in
22 the amount of \$2,000,635.00. The tenth check, dated April 3, 2014, was remitted to Wanzeler
23 and was made out to TelexFree Dominicana SRL in the amount of \$10,398,000.00. [See Stanley
24 Declaration, SEC Case, Docket No. 7].
25

26 13. Merrill and Wanzeler were also the sole managers and officers of TelexFree until
27 December 2013. Joseph Craft served as company accountant beginning in April 2012. Merrill
28

1 and Wanzeler hired him as “Acting CFO” in December, 2013. In February 2014, they hired
2 Stuart MacMillan as “Acting CEO.” On April 10, 2014, just 3 days before filing for
3 bankruptcy, Merrill and Wanzeler hired William H. Runge, III, the Managing Director with
4 Alvarez & Marsal (“A&M”), as the Chief Restructuring Advisor (“CRA”). [Runge Declaration,
5 Docket No. 13, pp. 1-2].
6

7 14. The minutes of the special meeting of the Board of Managers of TelexFree, LLC
8 held on April 13, 2014, indicate that Merrill and Wanzeler comprise the entire Board of
9 Managers (the “Board”). [See Docket No. 1, pp. 5-7]. At this meeting, Merrill and Wanzeler
10 selected Craft and MacMillan as the Debtors’ “Authorized Persons,” empowered to execute
11 and file pleadings on behalf of the Debtors, to employ counsel and other professionals
12 (including Craft’s accounting firm), and to exercise signature authority over the Debtors’
13 accounts. Although the minutes include language revoking any prior signature authority of
14 other individuals, there is no language stating that Merrill and Wanzeler are stepping down from
15 the Board or that anyone else is stepping up to serve as their replacements. On information and
16 belief, the new interim CFO and CEO still report to and take direction from the Board which is
17 still comprised of 2 individuals – Merrill and Wanzeler.
18
19

20 15. No schedules or statements of financial affairs and have been filed in these cases.
21 On April 21, 2014, the Debtors filed a *Motion to Extend Deadline to File Schedules* on OST,
22 requesting that the deadline be extended until June 16, 2014. [Docket Nos. 62-64]. The Section
23 341 Meeting of Creditors is currently docketed for May 15, 2014. [Docket No. 2]. Most of the
24 first day motions have been continued to May 2, 2014, however, those concerning cash
25 management, payments to employees and to taxing authorities will be moot if the SEC’s TRO
26 becomes a preliminary injunction.
27
28

16. The United States Trustee requests that the Court take judicial notice of the pleadings and documents filed in this case pursuant to FED. R. BANKR. P. 9017 and FED. R. EVID. 201. To the extent that this Objection contains factual assertions predicated upon statements made or documents filed by the Debtors, or their agents or representatives, the United States Trustee submits that such factual assertions are supported by admissible evidence in the form of admissions of a party opponent under FED. R. BANKR. P. 9017 and FED. R. EVID. 801(d)(2).

17. The United States Trustee requests that the Court take judicial notice of the case currently pending in the United States District Court, District of Massachusetts (*Securities and Exchange Commission v. Telexfree, Inc. et al*, Case No. 1:14-cv-11858-DJC) and the administrative complaint filed by the Secretary of the Commonwealth of Massachusetts, Securities Division (*In the Matter of TelexFree, Inc & TelexFree, LLC (E-2014-0004)*).

III. ARGUMENT

A. The Appointment of a Chapter 11 Trustee is Required.

18. The United States Trustee requests the Court to order the appointment of Chapter 11 trustee pursuant to 11 U.S.C. § 1104(a)(1). Cause has been established in these cases by the fraudulent and dishonest acts committed by the principals and officers of the Debtors, as detailed herein. Specifically, Merrill, Wanzeler, Craft, and possibly others have engaged in securities fraud, withheld material information from investors, and improperly diverted millions of dollars of estate property to themselves or their entities, as set forth in the SEC Complaint and Memorandum. Once cause is established, the Court must order the appointment of a trustee pursuant to section 1104(a)(1).

1 19. Ponzi schemes are fraudulent by definition. A Ponzi scheme is a financial fraud
2 that induces investment by promising extremely high, risk-free returns, usually in a short time
3 period, from an allegedly legitimate business venture. *Donell v. Kowell*, 533 F.3d 762, 767
4 n. 2 (9th Cir. 2008), *cert. denied*. ___ U.S. ___, 129 S.Ct. 640, 172 L.Ed.2d 612 (2008). The
5 fraud consists of funneling proceeds received from new investors to previous investors in the
6 guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate
7 profit-making business opportunity exists and inducing further investment. *In re United Energy*
8 *Corp.*, 944 F.2d 589, 590 n. 1 (9th Cir. 1991). Fraud, before or after the filing of a bankruptcy
9 case, is a ground to appoint a trustee. *In re Vaughan*, 429 B.R. 14 (Bankr. D.N.M. 2010).

10
11
12 20. In order to prove that a Debtor engaged in a Ponzi scheme, the plaintiff must
13 prove: “(1) deposits were made by investors; (2) the Debtor conducted little or no legitimate
14 business operations as represented to investors; (3) the purported business operations of the
15 Debtor produced little or no profits or earnings; and (4) the source of payments to investors was
16 from cash infused by new investors.” *In re Canyon Systems Corp.*, 343 B.R. 615, 630 (Bankr.
17 S.D. Ohio 2003). Given the facts alleged in the SEC Case, TelexFree appears to be engaged in
18 a classic Ponzi scheme.

19
20 20. These cases are replete with specific allegations of fraud, dishonesty, and gross
21 mismanagement by current officers and directors. [See SEC Complaint, SEC Case, Docket 2].
22 Although naked allegations of misconduct, standing alone, are an insufficient basis for the
23 appointment of a trustee, it is not necessary for the Court to conduct a mini-trial of each of the
24 factual allegations in the SEC Complaint. Rather, appointment of a trustee is mandated if this
25 Court determines that the allegations have a “substantial basis in the facts.” *In re American*
26 *Resources, Ltd.*, 54 B.R. 245, 247 (Bankr. D. Hawaii 1985); *see also Tradex Corp. v. Morse*,
27
28

339 B.R. 823 (D. Mass. 2006) (finding, in case decided under preponderance of the evidence standard, that the bankruptcy court properly ordered appointment of a trustee based on credible, though disputed, allegations against debtor that were the subject of a grand jury proceeding).

B. Cause is Established Under 11 U.S.C. § 1104(a)(1).

21. Section 1104(a)(1) of the Code provides:

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court *shall* order the appointment of a trustee -

(1) for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

11 U.S.C. § 1104(a)(1) (emphasis added).

22. Section 1104(a) of the Bankruptcy Code is rooted in the concept of the debtor's fiduciary duty and obligation owed to all of its creditors and parties-in-interest. *See, e.g., Wolf v. Weinstein*, 372 U.S. 633, 649 (1963) ("[S]o long as the Debtor remains in possession, it is clear that the corporation bears essentially the same fiduciary obligations to the creditors as does the trustee for the Debtor out of possession."); *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985) (stating that the willingness to leave debtors in possession is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibility of a trustee).

23. By including the mandatory auxiliary verb "shall," Section 1104 requires the appointment of a chapter 11 trustee once cause has been established. The statutory term "cause," however, is not defined in either Sections 101 or 1104.

1 24. The examples of cause in Section 1104 of the Code are preceded by the term
2 "including." 11 U.S.C. § 1104(a)(1). Under the Code's rules of construction set forth in Section
3 102, the term "including" is not limiting. 11 U.S.C. § 102(3). Finally, Section 1104(a)(1) of the
4 Code includes the phrase "or similar cause," leading to the conclusion that the examples of cause
5 set forth in Section 1104(a)(1) are just that - examples.
6

7 25. Indeed, courts that have been called upon to apply Section 1104(a)(1) have
8 concluded that the list of examples of cause set forth therein is non-exhaustive. *See, e.g., In re*
9 *SunCruz Casinos, LLC*, 298 B.R. 821, 828 (Bankr. S.D. Fla. 2003) (describing the list of
10 examples of cause set forth in Section 1104 of the Code as "non-exhaustive"); *In re Microwave*
11 *Prods. of America, Inc.*, 102 B.R. 666, 671 (Bankr. W.D. Tenn. 1989) (noting that courts may
12 consider both pre-petition and post-petition conduct in determining whether cause exists to
13 appoint a Chapter 11 trustee).
14

15 26. Broad construction of the term "cause" not only pays fidelity to the text of
16 Sections 1104(a)(1) and 102(3), such a construction properly recognizes the role of a Chapter 11
17 trustee as a potential check on abuse or disregard of creditor and/or interest holder goals by a
18 debtor-in-possession that fails to discharge its fiduciary duties. *See In re V. Savino Oil &*
19 *Heating Co.*, 99 B.R. 518, 525 (Bankr. E.D.N.Y. 1989) ("Section 1104(a) represents a
20 potentially important protection that courts should not lightly disregard or encumber with overly
21 protective attitudes towards the debtor-in-possession.").
22
23

24 27. In addition to giving credence to the non-exhaustive nature of the list of
25 examples of cause, courts have imbued the term "cause" with additional meaning and substance
26 by identifying the following six factors courts should evaluate in determining whether to appoint
27 a Chapter 11 trustee:
28

- (1) Materiality of misconduct;
- (2) Evenhandedness or lack of same in dealings with insiders or affiliated entities vis-a-vis other creditors or customers;
- (3) The existence of prepetition voidable preferences or fraudulent transfers;
- (4) Unwillingness or inability on the part of management to pursue estate causes of action;
- (5) Conflicts of interest on the part of management interfering with its ability to fulfill its fiduciary duties to the debtor;
- (6) Self-dealing by management or waste or squandering of corporate assets.

Sun Cruz Casinos, 298 B.R. at 830, citing *In re Intercat, Inc.*, 247 B.R. 911, 921 (Bankr. S.D. Ga. 2000) and *In re Bellevue Place Assocs.*, 171 B.R. 615, 622 (Bankr. N.D. Ill. 1994).

28. Establishment of just one of the factors listed above constitutes sufficient cause to appoint a chapter 11 trustee. See *Matter of Cajun Elec. Power Co-op., Inc.*, 74 F.3d 599 (5th Cir. 1996). The United States Trustee submits that the record before the Court establishes the existence of all of the *Intercat* factors constituting “cause” on the part of Debtors’ current management under either the ‘preponderance of the evidence’ standard or the ‘clear and convincing evidence’ standard of proof.

29. Parties seeking the appointment of a trustee pursuant to 11 U.S.C. § 1104(a)(1) bear the burden of proving by a preponderance of the evidence that the appointment of a trustee is appropriate. The higher standard of clear and convincing evidence does not control. See *Tradex Corp. v. Morse*, 339 B.R. 823, 830 (D. Mass. 2006) (noting that “general Supreme Court reasoning in the bankruptcy realm suggests that the reflexive endorsement of a demanding ‘clear and convincing’ evidentiary burden regarding trustee appointments under § 1104 is anomalous.”); *In re Altman*, 230 B.R. 6, 16-17 (Bankr. D. Conn. 1999), vacated in

part on other grounds, 254 B.R. 509 (D. Conn. 2000) (same); *see also Grogan v. Garner*, 498 U.S. 279, 286 (1991) (noting that the general standard of proof in civil and bankruptcy cases, and in nondischargeability litigation in particular, is a preponderance of the evidence).

C. Appointment of a Trustee is in the Interests of Creditors and the Estates.

30. Section 1104(a)(2) of the Bankruptcy Code provides an alternative to “cause” as grounds for the Court to order the appointment of a trustee:

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

11 U.S.C. § 1104(a)(2).

31. Under Section 1104(a)(2), courts eschew rigid absolutes and look to the practical realities and necessities. *In re Taub*, 427 B.R. 208, 227 (Bankr. E.D.N.Y. 2010) (quoting *In re Adelphia Communication Corp.*, 336 B.R. 610, 658 (Bankr. S.D.N.Y. 2006)); *In re Euro-American Lodging Corp.*, 365 B.R. 421, 427 (Bankr. S.D.N.Y. 2007). In determining whether the appointment of a trustee is in the best interests of creditors, a bankruptcy court must necessarily resort to its broad equity powers. Moreover, equitable remedies are a special blend of what is necessary, what is fair, and what is workable. *Schuster v. Dragone*, 266 B.R. 268, 272-273 (D. Conn. 2001) (quotations omitted).

32. Accordingly, the standard for appointment of a Chapter 11 trustee under Section 1104(a)(2) is flexible. *See* 124 Cong.Rec. H11, 102 (daily ed. Sept. 28, 1978); S17, 419 (daily ed. October 6, 1978). The House Report summarizes the reasons for Congress' adoption of a flexible standard for the appointment of trustees and reads, in part, as follows:

The twin goals of the standard for the appointment of a trustee should be protection of the public interest and the interests of creditors, as contemplated in current chapter X and facilitation of a reorganization that will benefit both the

creditors and the debtors, as contemplated in current chapter XI. Balancing the goals is a difficult process, and requires consideration of many factors.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 232 (1977), U.S. Code Cong. & Admin. News 1978, p. 6192.

33. The factors considered by the courts in assessing motions brought under this section include: (1) the trustworthiness of the debtor, (2) the debtor's past and present performance and prospects for rehabilitation, (3) the confidence – or lack thereof – of the business community and of creditors in present management, and (4) the benefits derived from the appointment of a trustee, balanced against the cost of the appointment. *Euro-American*, 365 B.R. at 427.

34. The appointment of a trustee in the instant cases is clearly in the best interests of creditors and the estates pursuant to Section 1104(a)(2). The Debtors' principals are not trustworthy in light of the pending SEC Case and the granting of the TRO by the District Court for the District of Massachusetts. As set forth above, allegations made in the SEC Complaint indicate that Merrill and Wanzeler, with the assistance of Craft, among others, have been operating a large scale Ponzi scheme to the detriment of TelexFree's Promoters – who, on information and belief, are also the Debtors' largest creditors. [See Docket No. 1]. It is clearly in the interests of the Debtors' estates and their creditors to take management control out of the hands of the current board members and give it to an independent trustee who will comply with the fiduciary duties mandated by the Bankruptcy Code.

D. New Officers Do Not Negate Past or Protect Against Future Fraudulent Acts of the Debtors' Board.

35. Although, Merrill and Wanzeler have supposedly stepped down as the Debtors' officers prior to filing for bankruptcy and hired Craft and MacMillan as Acting CFO and CEO,

1 Merrill and Wanzeler remain the sole members of the Debtors' Board, thereby retaining
2 complete control over the officers they have hired to replace them. Furthermore, the SEC
3 Complaint names Craft as a co-defendant and alleges that he has been an active participant and
4 co-conspirator in the fraud and self-dealing of these Debtors both pre and post-petition.
5

6 36. While (on information and belief) there have been no allegations to date regarding
7 the involvement of MacMillan (the new CEO) or Runge (the new CRA) in the Debtors' Ponzi
8 scheme, neither is there any indication that these interim officers are truly independent of the
9 fraud of "former" management. The *modus operandi* of Merrill and Wanzeler and their cohorts
10 suggests that it is more likely than not that anyone handpicked by them to manage their wholly
11 owned companies will be another cohort. The only way to ensure honest and independent
12 management of these Debtors going forward is for the Court to direct the United States Trustee
13 to appoint a Chapter 11 trustee.
14

15 **WHEREFORE**, the United States Trustee respectfully requests that the Court enter an
16 order directing the appointment of a Chapter 11 trustee and granting such other and additional
17 relief as is just and equitable.
18

19 Dated: April 22, 2014

20 **TRACY HOPE DAVIS**
21 **UNITED STATES TRUSTEE, REGION 17**

22 By: /s/ J. Michal Bloom
23 J. Michal Bloom, Esq.
24 Attorney for the United States Trustee
25
26
27
28

Exhibit 1

Scott Andrew Farrow
Acting Assistant United States Trustee
State Bar No.: WI 1000609
scott.a.farrow@usdoj.gov

J. Michal Bloom, Trial Attorney
State Bar No.: NV 4706
j.michal.bloom@usdoj.gov

UNITED STATES DEPARTMENT OF JUSTICE

Office of the United States Trustee
300 Las Vegas Boulevard, So., Suite 4300
Las Vegas, Nevada 89101
Tel: (702) 388-6600
Fax: (702) 388-6658

Attorneys for the United States Trustee for Region 17
TRACY HOPE DAVIS

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEVADA

In re:

TELEXFREE, LLC,

☐ AFFECTS THE DEBTOR

☒ AFFECTS ALL DEBTORS

☐ AFFECTS TELEXFREE, INC.

☐ AFFECTS TELEXFREE FINANCIAL, INC.

CASE NO. BK-S-14-12524
Chapter 11

[PROPOSED]

Jointly Administered with:

14-12525-abl Telexfree, Inc.
14-12526-abl Telexfree Financial, Inc.

Date: OST Pending
Time: OST Pending

ORDER DIRECTING THE UNITED STATES TRUSTEE TO
APPOINT A CHAPTER 11 TRUSTEE PURSUANT TO §1104(a)

1 Based on the *Motion of the United States Trustee for Order Directing the Appointment of*
2 *a Chapter 11 Trustee Pursuant to § 1104(a)*, the hearing held on _____ (date), (appearances
3 noted on the record), the Court having stated on the record its findings of fact and conclusions of
4 law, which are incorporated herein pursuant to Federal Rules of Bankruptcy Procedure 9014(c)
5 and 7052, and Federal Rule of Civil Procedure 52, with good cause having been shown,
6

7 **IT IS HEREBY ORDERED** that the United States Trustee is directed to appoint a
8 Chapter 11 trustee.
9

10 Submitted by:
11

12 TRACY HOPE DAVIS
13 UNITED STATES TRUSTEE

14 By: /s/ J. Michal Bloom
15 J. Michal Bloom, Esq.
16 United States Department of Justice
Attorney for the United States Trustee
17
18
19
20
21
22
23
24
25
26
27
28