Docket #0623 Date Filed: 10/7/2015

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS
CENTRAL DIVISION

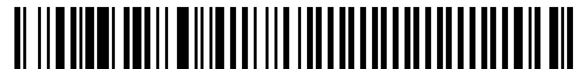
In Re:	
	Chapter 11
TELEXFREE, LLC ,	**Case No. 14-40987-MSH**
TELEXFREE, INC.,	**Case No. 14-40988-MSH**
TELEXFREE FINANCIAL, INC.,	**Case No. 14-40989-MSH**
Debtors.	**Jointly Administered**

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 requests entry of an order finding that the Debtors were engaged in a Ponzi/pyramid scheme and that such finding be applicable to all matters in these proceedings. The Trustee has filed simultaneously herewith the *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") and 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").

In support of this motion (the "Motion"), the Trustee states as follows:



INTRODUCTION

The Debtors ostensibly operated a multi-level marketing company engaged in the sale of voice over internet service but, as detailed herein, the Debtors' operations actually were a massive Ponzi/pyramid scheme that ensnared as many as a million or more participants from multiple countries (hereinafter, parties who became members of the Debtors' scheme shall be referred to as "Participants"). Participants opened approximately 11,000,000 User Accounts (as hereafter defined) and purchased membership plans and/or Voice over Internet Protocol ("VoIP") service with a transaction value of approximately $3,070,000,000 during the approximately two years of the Debtors' operation of their scheme. An affiliate of the Debtors, Ympactus Comercial Ltda. ("Ympactus"), reportedly operated a substantially similar scheme in Brazil which was seized and shut down by the Brazilian authorities in June 2013.[1] Shortly after the Debtors' Chapter 11 filings in April 2014, the Securities and Exchange Commission and the Massachusetts Securities Division commenced litigation against the Debtors and others alleging, among other things, that the Debtors were engaged in the fraudulent sale of securities in violation of numerous securities laws. Contemporaneously therewith, substantially all of the Debtors' assets and records were seized by the federal authorities. Approximately two months later, on June 6, 2014, the Trustee was appointed.

The Trustee has conducted an extensive investigation into the operations of the Debtors' scheme and Participant involvement therein. As a result of the investigation, the Trustee has concluded that and requests a finding from the Court that the Debtors were engaged in a Ponzi/pyramid scheme, that any claim or portion of claim of Participants based upon accumulated credits arising from fictitious profits or commissions in Participants' User Accounts

[1] Reportedly, Ympactus was recently found by a Brazilian court to have been a Ponzi scheme.

as of the Petition Date should be disallowed, and that Participant claims should be determined on a "net equity" basis.

Simultaneously herewith, the Trustee has 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 seeks, among other things, approval for the electronic noticing of a Bar Date and approval of the content of electronic proofs of claim to be filed by Participants (the "Participant ePOC") and non-Participants (the "Standard ePOC" and together, the "ePOCs").

I. CASE BACKGROUND AND PROCEDURAL POSTURE

1. 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").

2. The Debtors initially operated as debtors-in-possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code.

3. On the Petition Date, the Debtors filed a motion for joint administration of the cases, with TelexFree, LLC designated as the lead case. By order dated April 24, 2014, the order for joint administration was approved.

4. 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.

5. 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/pyramid scheme and the fraudulent unregistered offering of securities. Substantially 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.

6. On or about April 22, 2014, the Office of the United States Trustee filed a motion for the appointment of a Chapter 11 Trustee based upon the allegations of illegal activity.

7. On April 23, 2014, the SEC filed a motion to transfer venue of the cases to the United States Bankruptcy Court for the District of Massachusetts (the "Court"). By order dated May 6, 2014, the motion to change venue was approved. The cases were transferred to the Court on May 9, 2014.

8. On May 30, 2014, this Court allowed the United States Trustee's motion to appoint a Chapter 11 trustee, and the Trustee was appointed on June 6, 2014.

9. The Debtors filed only a list of the alleged thirty (30) largest creditors in the cases and did not file schedules or statements of financial affairs, nor a matrix of creditors.

10. On February 27, 2015, the Trustee filed schedules of assets and liabilities and statements of financial affairs for each of the Debtors, using information obtained from documents produced pursuant to Rule 2004 examinations and Debtor records obtained from the Federal Authorities (as defined below).

11. Carlos Wanzeler and James Merrill were the Debtors' principals along with Carlos Costa, at least through Costa's alleged separation from the Debtors in the fall of 2013. Shortly after the Trustee was appointed, the United States Department of Justice ("DOJ" and, together with the SEC and HSI, the "Federal Authorities") indicted Wanzeler and Merrill based upon their involvement in the Debtors' scheme. Wanzeler has fled the country and is believed to be in Brazil. Merrill was initially detained and has been released pending trial.

12. On February 3, 2015, the Trustee submitted a comprehensive Status Report on outstanding matters in the cases. The Status Report set forth, among other things, the background of the Debtors and their affiliates, the breadth and scope of the scheme, assets recovered to date and potential additional sources of recovery, as well as efforts at coordination with governmental authorities, both in the United States and in Brazil.

13. Prior to the Trustee's appointment, the Federal Authorities shut down, disconnected, and seized the Debtors' computer system, which consisted of forty-six (46) computers and servers containing more than twenty (20) terabytes of data. Accordingly, at the time of his appointment, the Trustee did not have access to any of the Debtors' records. Neither of the Debtors' principals has been available because Wanzeler fled the country and Merrill had been indicted and detained. The Trustee has only had limited access to the Debtors' former employees.

14. Initially without access to the Debtors' books and records, the Trustee has utilized a variety of resources to obtain information regarding the Debtors' activities and the mechanics of their scheme. The Trustee filed motions for authority to obtain documents from, and conduct examinations of, twenty-nine (29) separate entities pursuant to Federal Rule of Bankruptcy Procedure 2004 (the "2004 Motions").[2] The deponents of the 2004 Motions included prepetition and postpetition professionals retained by the Debtors, financial institutions who had prepetition and/or postpetition relationships with the Debtors, multiple firms who provided payment processing services to facilitate payments between the Debtors and Participants, and firms who provided consulting services to the Debtors or who otherwise were believed to have had business relationships with the Debtors. The Trustee also conducted informal interviews of certain former employees and consultants of the Debtors as well as several Participants.

A. Mechanics of Scheme and Methods of Compensation

15. The Debtors purported to be in the business of selling VoIP that cost $49.90 per month to conduct international phone calls. The sale of VoIP on a monthly basis is hereinafter referred to as a "VoIP Package". Customers who purchased the VoIP Package registered their phone numbers with the Debtors and received software that enabled their computers to place phone calls through the Debtors' computer servers in Marlborough, Massachusetts to approximately 40 countries.

16. The Debtors ostensibly used a multi-level marketing plan, or "MLMP", to sell the VoIP Packages. An MLMP, also referred to as network marketing or referral marketing, is a direct sales strategy in which the sales force is compensated not only for sales they generate, but also for the sales generated by other sales persons that they recruit. *Whole Living, Inc. v. Tolman*, 344 F. Supp. 2d 739 (D. Utah 2004). MLMP businesses can be legitimate, and notable

[2] To date, the Trustee has deferred conducting depositions of the 2004 Motion deponents.

examples of MLMP's include Herbalife International (selling nutritional supplements, weight management, sports nutrition, and personal care products), Mary Kay, Inc. (selling cosmetics products), and Amway (selling, among other things, health, beauty, and home care products).

17. Each new distributor in an MLMP recruited by a participant, along with the recruited distributor's recruits (down to six levels in the Debtors' case), becomes part of the first participant's "network", sometimes referred to as the participant's "downline." Eventually one or more pyramid type structures is established underneath the recruiting participant. In addition to earning commission and profits on the products the participant sells, he or she is entitled to receive a commission based on the volume of products or memberships sold by his or her network.

18. Until the Debtors purported to change their MLMP contracts in an unsuccessful attempt to address the existing contract's illegality in March 2014, the Debtors provided Participants with two options (in addition to purchasing VoIP Packages) to become members and to thereby open User Accounts:

a. "<u>AdCentral Plan</u>": $339 for a one-year contract ($50 membership fee plus $289 contract fee). This contract entitled the User Account holder with the right to sell ten VoIP Packages, for which a Participant could receive a commission if the packages were sold, although there was no sale requirement. Participants were required to place one internet ad per day and, for each week in which the Participant placed the required ads, he/she was entitled to one additional VoIP Package, which could be sold or exchanged for $20 in credits with the Debtors. Thus, Participants who posted the required ads were eligible to receive $20 per week for 52 weeks, for a total return of $1,040 (a return of 207% on the investment of $339).

b. "<u>AdCentral Family Plan</u>": $1,425 for a one-year contract ($50 membership fee plus $1,375 contract fee). This contract entitled the User Account holder with the right to sell fifty VoIP Packages, for which a Participant could receive a commission if the packages were sold, although there was no sale requirement. Participants were required to place five internet ads per day and, for each week in which the Participant

placed the required ads, he/she was entitled to five additional VoIP Packages, which could be sold or exchanged for $100 in credits with the Debtors. Thus, the Participants who posted the required ads were eligible to receive $100 per week for 52 weeks, for a total return of $5,200 (a return of 265% on the investment of $1,425).

19. In addition to credits for posting these advertisements, the Debtors issued credits to Participants for the sale of membership plans and the establishment of new User Accounts as follows:

a. $20 in credits for each new AdCentral Plan and $100 in credits for each new AdCentral Family Plan in a Participant's network.

b. $20 in credits for each User Account in one's "network," up to a maximum of $440, as long as there were two subsidiary User Accounts.

c. 2% of all payments to each User Account within one's network, down to six "levels" of the network, provided that each User Account had a registered VoIP customer.

d. 2% of the Debtors' net monthly billing, up to a maximum of $39,600 in credits, for an AdCentral Family Plan that had ten new AdCentral Family Plans in its network, so long as each plan had five registered VoIP customers.

20. The Debtors also issued credits to Participants for the sale of VoIP Packages as follows:

a. 90% (or $44.90 in credits) for the initial sale of a VoIP Package at $49.90.

b. 10% (or $4.99 in credits) per month for the renewal of a VOIP Package by a User Account holder directly in one's network[3] and 2% (or $0.99 in credits) per month for the renewal of a VOIP Package by a User Account holder indirectly in one's network, down to six levels of the network.

c. 2% from all VoIP Package sales in one's network, down to six levels of the network.

[3] In practice, the Debtors appear to have provided Participants with credits equal to ninety percent (90%) of the renewal fees.

21. The credits issued to Participants for placing advertisements and selling membership plans and VoIP Packages could be redeemed for cash, transferred to another User Account, or applied in satisfaction of an invoice for another User Account.

22. Invoices for the purchase of a membership plan could be satisfied in one of two ways. Participants could pay the invoice in cash directly to the Debtors or Participants could pay a recruiting Participant for the purchase of a membership plan through the recruiting Participant's redemption of credits from the Debtors.

23. In the case of a Participant satisfying his/her own invoice by payment in cash to the Debtors, the process worked, generally, as follows:

a. The Participant joined the Debtors' organization and created an online account with the assistance of a recruiting Participant, who needed to be identified;

b. The Debtors' database recorded the information entered by the recruited Participant and assigned an identification number to the new User Account;

c. The Debtors recorded the purchase, issued an invoice number, and marked the invoice as 'pending';

d. A Participant would pay money directly to the Debtors in the form of cash, check, cashier's check, or wire transfer, or through a third-party online payment processing account. Once the Participant paid the invoice, the Debtors updated the invoice as 'paid', and the account setup would be complete;

e. The recruited Participant could then start building a pyramid underneath the newly created User Account by recruiting other Participants (or by purchasing new User Accounts themselves) and generating bonuses and commissions in accordance with the scheme.

24. Alternatively, a Participant could satisfy his/her own invoice directly by payment in cash to another Participant, who would, in turn, satisfy the invoice by a redemption of

accumulated credits. Thus, the recruited Participant's membership fee for TelexFree plan was paid to the recruiting Participant, rather than to the Debtors.

25. As set forth above, there are approximately 11,000,000 User Accounts associated with the Debtors' MLMP. A new User Account was generally established each time that a membership plan was purchased, with either cash or accumulated credits.

26. Although some versions of Participant contracts contained prohibitions against Participants opening multiple User Accounts for themselves, other plan descriptions did not. In any case, any such restriction was not enforced and could not be enforced since the Debtors did not verify the Participants' identities. The Debtors' MLMP structure created incentives for Participants to open multiple User Accounts to generate credits for themselves.

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

28. In fact, it was a regular practice of the Debtors' scheme that membership fees were paid by the use of accumulated credits rather than by cash. While invoices associated with the sale of membership plans or VoIP Packages had a face value of approximately $3,070,000,000, only $360,000,000, or approximately twelve percent (12%) of that amount, was paid in cash to the Debtors. The balance of these invoices was satisfied by the use of Participants' credits.

29. The Debtors also issued "manual credits" to certain User Accounts. Manual credits were credits issued to User Accounts unrelated to the purchase of a membership plan and not resulting from the placement of advertisements or other components of the compensation scheme. Although some manual credits may have been issued to User Accounts in exchange for cash payment to the Debtors, the Trustee is unable to identify any payment to the Debtors for a significant amount of manual credits that were issued to certain User Accounts. These credits issued without consideration appear to be a fraud within the larger fraud of the Ponzi/pyramid scheme. There also were exchanges of credits between User Accounts unassociated with the issuance and satisfaction of Debtor invoices.

B. SIG/Back Office

30. The Debtors maintained two computer applications for accessing and processing information from the Debtors' database relating to User Account activity, referred to as "SIG" and the "Back Office".[4]

31. SIG stands for Sistemas de Informacoes Gerenciais, which is Portuguese and translates roughly to "Information Management System." SIG tracked the activity for Participants by User Account, and the User Accounts are the only records available to the Trustee to confirm Participant activity.

32. The Trustee's access to SIG was the culmination of a painstaking data recovery and analysis project implemented by the Trustee and his team of professionals with the assistance of investigators from HIS and the SEC.

33. Following the Trustee's appointment and beginning in August 2014, HSI provided copies of electronic information contained in the Debtors' computers and servers to the

[4] The Back Office was the program used by Participants to obtain information on their User Account activity.

Trustee. Once all of the data from the Debtors' computers and servers were obtained, the Trustee and his team "virtualized" (i.e., created a computer environment replicating the original configuration) the system following a multi-step process, since the Federal Authorities were in possession of the original servers.

34. Extensive testing was performed to determine that the appropriate configurations of the data were achieved. Data from additional servers were later identified that were necessary to operate the network. Once the key components of the system were identified and operating, passwords were obtained through research into document productions received by the Trustee, communications with Federal Authorities, and a variety of investigative tools. Finally, an intensive analysis was performed to better understand the database structure, table relationships, data fields, and process flow.

35. The result was a working version of SIG, which enabled the Trustee and his professionals to conduct search queries and sort data. Because SIG was complicated, written in more than one language, and poorly maintained, and system documentation was unavailable, substantial additional hurdles remained to achieving an understanding of the system and extracting usable data.

36. The Debtors' database was developed by programmers in Brazil and all field references are in Portuguese. The developers apparently lacked the expertise to create and manage a system of this magnitude. As a result, system modifications appear to have been done in a haphazard and disorganized fashion. In addition, the Debtors' system is permeated with unreliable data because of limited efforts at data validation of information provided by Participants in establishing User Accounts.

37. Despite all of these obstacles, as a result of the forensic efforts identified above, the Trustee and his team have been able to reconstruct the Debtors' computer system in a virtual environment and obtain a working understanding of SIG and how it was used to track User Account activity.

38. Each time that a Participant purchased a membership plan or VoIP Package, an account was established with SIG (the "User Account").

39. Each User Account with the Debtors was registered with an electronic mail address (an "Email Address"). There are approximately 900,000 unique Email Addresses in SIG associated with approximately 11,000,000 Debtor User Accounts. The number of User Accounts associated with an Email Address varies widely. A particular Email Address may be associated with only a single User Account or may be associated with hundreds or thousands of User Accounts. Because each User Account may represent a separate Participant and some Participants entered the scheme using the Email Address of another Participant, the number of Participants is unknown but is likely in excess of 1,000,000.

40. After a User Account was established, SIG tracked the activity of the Participant in that User Account, including the accumulation of credits for bonuses and commissions "earned", the use or transfer of credits between User Accounts, and payments made to or from the Participant directly with the Debtors.

41. The Trustee and his team have taken a series of steps to confirm the accuracy and reliability of the transaction data reflected in SIG. The Trustee interviewed the Debtors' bookkeeper to understand the mechanics of SIG and how it was employed on a day to day basis. Testing was performed to reconcile balances and activity using available data, which is somewhat limited. This testing included cross-referencing data in related transactions and

conducting interviews with several Participants to confirm the accuracy of the SIG data as to their User Accounts. Based on the testing performed to date, SIG transaction data appears to have integrity and provides accurate information regarding membership plan sales, issuance of invoices, accumulation and use of credits, and amounts received from and disbursed to the User Accounts.

C. Relationship with Ympactus, and Segregation of Ympactus Information and Debtor Information

42. In February 2012, Ympactus reportedly commenced operations in Brazil to operate a scheme substantially identical to the scheme that is described above. Ympactus initially grew much more rapidly than the Debtors, with growth accelerating in the fall of 2012 through the early summer of 2013. By the spring of 2013, Ympactus had cash receipts of more than $100,000,000 per month. *See Darr Affidavit, Exhibit "A"*, at ¶51. On the other hand, the Debtors' cash receipts were initially much more modest. In the spring of 2013, the Debtors' cash receipts averaged approximately $6,400,000 per month. *See Darr Affidavit, Exhibit "A"*, at ¶51.

43. On June 28, 2013, the Public Prosecutor's Office of the State of Acre, Brazil filed claims against Ympactus, Carlos Wanzeler, Lyvia Mara Campista Wanzeler, and James Merrill, alleging that the VoIP Packages marketed in Brazil were violating consumer rights, since the MLMP constituted a Ponzi/pyramid scheme. The Brazilian authorities suspended the operations of Ympactus and froze its assets. Upon information and belief, the Brazilian authorities seized as much as $300,000,000 from Ympactus in connection with the shutdown, and civil and criminal proceedings are pending in Brazil.[5]

[5] The Trustee is exchanging information with Brazilian authorities and is trying to develop a common protocol for administering claims and pursuing recoveries in the respective cases of Ympactus and the Debtors.

44. Upon information and belief, on or about September 21, 2015, the Brazilian court entered a decision finding that Ympactus operated a pyramid scheme.

45. Following the shutdown of Ympactus, the Debtors' cash receipts increased dramatically. The Debtors' cash receipts totaled approximately $200,000,000 in the last three full months of operation, with more than $96,000,000 in cash receipts in February 2014 alone. *See Darr Affidavit, Exhibit "A"*, at ¶53.[6]

46. The SIG system maintained by the Debtors and Ympactus operated with a single database reflecting User Account activity for both operations. After reconstructing the computer network and developing a working understanding of SIG, one of the Trustee's first tasks was to determine how to segregate the Debtors' activity from that of Ympactus, since SIG did not clearly differentiate the User Accounts between Ympactus and the Debtors' Participants.

47. SIG includes more than 17,000,000 distinct User Accounts associated with approximately 2,000,000 Email Addresses for both the US-based and the Brazilian-based operations.

48. In creating a new User Account, each Participant was directed to identify whether such Participant would pay the initial invoices in Brazilian Reais ("Reais") or United States Dollars. Through a review of the currency field data, the Trustee determined the following:

a. Prior to the shutdown of Ympactus in June 2013, invoices in User Accounts with Brazilian contact information were denominated in Reais and invoices in User Accounts with non-Brazilian contact information were denominated in Dollars;

[6] Attached as Exhibit 1 to the Darr Affidavit is a summary of cash receipts of the Debtors, by month, for the two years of operation of the scheme.

b. Fewer than 700 Reais-denominated User Accounts were associated with non-Brazilian addresses. Similarly, fewer than 150 Dollar-denominated User Accounts were associated with Brazilian addresses; and

c. There was relatively little activity after the shutdown of Ympactus for Reais-denominated User Accounts that were created prior to the shutdown, and all cash activity for Reais-denominated accounts ceased shortly after the shutdown.

49. The Trustee believes that the Debtors' User Accounts can be separated from Ympactus' User Accounts by the currency designation in the data fields as described above.

50. Utilizing the currency designation, it appears that approximately 11,000,000 User Accounts are associated with the Debtors' operations and approximately 4,000,000 User Accounts are associated with Ympactus operations and the remaining 2,000,000 User Accounts had no activity.

II. FINDING OF EXISTENCE OF PONZI AND PYRAMID SCHEME

51. The Debtors conducted a Ponzi/pyramid scheme, not a legitimate MLMP.

52. Pyramid schemes and Ponzi schemes share many similar characteristics and typically involve unsuspecting participants who are duped into paying money to join the scheme by unscrupulous operators promising extraordinary returns. In contrast to a legitimate investment, however, these types of schemes can only provide the promised returns if the number of participants continues to increase exponentially, as the money from later participants is the sole or primary source available to make payments to existing participants. *Webster v. Omnitrition Int'l, Inc.*, 79 F.3d 776, 781 (9th Cir. 1996); *United States v. Gold Unlimited, Inc.*, 177 F.3d 472, 479 (6th Cir. 1999); *In re First Commercial Mgmt. Grp., Inc.*, 279 B.R. 230, 232

(Bankr. N.D. Ill. 2002); *Rieser v. Hayslip (In re Canyon Sys. Corp.)*, 343 B.R. 615, 630 (Bankr. S.D. Ohio 2006); *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 531 B.R. 439, 470 (Bankr. S.D.N.Y. 2015).

53. A Ponzi scheme is generally based upon a fraudulent investment opportunity. Typically, investors contribute funds to the organizer who promises a high return. Existing investors are paid their returns almost exclusively from the funds contributed by new investors and not from the legitimate profits of the business. *Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 8 (S.D.N.Y. 2007); *Eberhard v. Marcu,* 530 F.3d 122, 132 n.7 (2d Cir. 2008); *accord In re Bernard L. Madoff Inv. Secs. LLC*, 654 F.3d 229, 232 (2d Cir. 2011), *cert. denied*, 133 S. Ct. 25 (2012); *see United States v. Moloney*, 287 F.3d 236, 242 (2d Cir. 2002) ("A Ponzi scheme by definition uses the purportedly legitimate but actually fraudulently obtained money to perpetuate the scheme, thus attracting both further investments and, in many cases, new investors to defraud."), *cert. denied*, 537 U.S. 951 (2002).

54. Some courts have discussed a four factor test to determine whether a Ponzi scheme exists: 1) deposits were made by investors; 2) the debtor conducted little or no legitimate business operations as represented to investors; 3) the purported business operation of the debtor produced little or no profits or earnings; and 4) the source of payments to investors was from cash infused by new investors. *Armstrong v. Collins*, 2010 WL 1141158, at *22 (S.D.N.Y. Mar. 24, 2010)(quoting *Forman v. Salzano (In re Norvergence, Inc.)*, 405 B.R. 709, 730 (Bankr. D.N.J. 2009)(quoting *In re Canyon Sys. Corp.*, 343 B.R. at 630); *accord Carney v. Lopez*, 933 F. Supp. 2d 365, 379 (D. Conn. 2013); *Wiand v. Waxenberg*, 611 F. Supp. 2d 1299, 1312 (M.D. Fla. 2009); *Kapila v. TD Bank, N.A. (In re Pearlman)*, 440 B.R. 900, 904 (Bankr. M.D. Fla. 2010); *Floyd v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424, 431 (Bankr. S.D. Tex. 1997).

55. Other courts have identified badges that weigh in favor of finding a Ponzi scheme, including the absence of any legitimate business connected to the investment program, the unrealistic promises of low risk and high returns, commingling of investor money, the use of agents and brokers that are paid high commissions to perpetuate the scheme, misuse of investor funds, the "payment" of excessively large fees to the perpetrator and the use of false financial statements. *See In re Dreier LLP,* 2014 WL 47774, at p. 9 (Bankr. S.D.N.Y. 2014). These badges are, however, merely characteristics of many Ponzi schemes but a Ponzi scheme can exist without all of them. *Id.* At bottom, the label Ponzi scheme applies "to any sort of inherently fraudulent arrangement under which the debtor-transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud." *In re Manhattan Inv. Fund*, 397 B.R. at 12 (quoting *Bayou Superfund v. WAM Long/Short Fund II, L.P. (In re Bayou Group, LLC)*, 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007) ("*Bayou I*")); *see Armstrong*, 2010 WL 1141158 at * 23 ("[E]ven assuming Yagalla did not promise or represent high rates of return, this does not mean that he was not running a Ponzi scheme. 'Case law has revealed that a clever twist on the Ponzi concept will not remove a fraudulent scheme from the definition of Ponzi.'") (quoting *In re Norvergence*, 405 B.R. at 730).

56. A pyramid scheme is generally characterized by a participant's payment to an MLMP operator in return for which participants receive the right to sell a product and the right to receive rewards for recruiting other participants substantially unrelated to the sale of product to ultimate users. *Webster*, 79 F.3d at 781(*quoting In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106 (1975)).

57. A pyramid scheme is a type of Ponzi scheme in that, in both instances, the scheme can only be sustained by the continued influx of new investors/participants to fund amounts

needed to be paid to earlier investors/participants. A Ponzi scheme generally involves only a direct, linear relationship between the owner of the scheme and the investors. The pyramid scheme, however, has two additional elements: the ostensible right to sell a product, and the payment to participants for the recruitment of new participants, thereby creating the pyramid structure.

58. An MLMP is a direct sales strategy in which members are compensated not only for sales the members generates, but also for the sales generated by other members that they recruit. Whether an MLMP operates as a pyramid scheme is determined by how it functions in practice. *Whole Living*, 344 F. Supp. 2d at 745. A lawful MLMP is distinguishable from a pyramid scheme in that the primary purpose of the enterprise and its associated individuals is to sell or market an end-product to end-consumers, and not to reward associated individuals for the recruitment of more participants. *Federal Trade Commission v. SkyBiz.com, Inc.*, 2001 WL 1673645, at *28 (N.D. Okla. Aug. 31, 2001).

59. The Debtors' compensation scheme had elements of both a Ponzi and pyramid scheme.

60. Participants who purchased an Ad Central or Ad Central Family Plan received the right to generate commissions for the sale of certain VoIP Packages but also were able to receive exceedingly high returns on their investments merely by placing meaningless, pre-drafted advertisements on selected websites without the requirement of selling any product. This guaranteed return on initial investment is a hallmark of a Ponzi scheme.

61. Participants who purchased the AdCentral Plan became entitled to receive a VoIP Package each week by placing one internet advertisement per day. These VoIP Packages could be, and routinely were, converted into credits with TelexFree for $20 weekly for 52 weeks, for a

207% return on the initial investment of $339. Participants who purchased the more expensive AdCentral Family Plan for $1,425 were entitled to receive five additional VoIP Packages each week by placing five internet advertisements per day. These VoIP Packages could be, and routinely were, converted into credits with TelexFree for $100 weekly for 52 weeks, for a return of 265% on the initial investment.

62. The repetitive posting of internet advertisements (which were reportedly supplied by the Debtors) served no legitimate purpose, because anyone who used "telexfree" as an internet search term would be led to the Debtors' own website; the repetitive posting of similar advertisements had no discernable value. For example, one website, Adpost.com, contained more than 33,000 postings submitted by Participants for TelexFree, while another, ClassifiedsGiant.com, contained more than 25,000 postings

63. The credits issued to Participants for placing advertisements were not reasonable compensation for performance of legitimate services. Participants did not draft the advertisements or perform any design services for their configuration, and the placing of the ads could be, and often was, outsourced to third parties for a nominal fee. The requirement of posting advertisements to receive weekly payments was intended to obfuscate the true nature of the scheme – that the credits were a disguised, "guaranteed" return on the Participant's initial investment.

64. The guarantee of an astronomical return on the initial investment without the requirement to sell any product created perverse incentives for Participants. Participants opened multiple User Accounts for the sole purpose of leveraging their fictitious profits, without the need to sell any product or recruit any individuals. Some Participants appear to have invested a substantial portion of their life savings into the scheme seeking to quickly triple or quadruple

their investment. Participants opened hundreds of User Accounts, ultimately resulting in an exponential rise in the number of User Accounts.

65. Participants who opened multiple User Accounts on their own behalf could generate credits by essentially recruiting themselves. Participants could receive (1) $20 worth of credits for recruitment of an AdCentral Plan member and $100 in credits for recruitment of an AdCentral Family Plan member, and (2) $20 in credits for each membership plan in one's downline, up to a maximum of $440 in credits, so long as that Participant recruited two new User Accounts in his/her downline by either opening User Accounts in his/her own name or by recruiting new Participants.

66. While there were certain provisions of the Debtors' MLMP that ostensibly required the sale of VoIP Packages as a requirement for receiving credits with TelexFree, the credits that could be generated for those activities were relatively insignificant and the requirements were easily circumvented by Participants.[7]

67. The Debtors had $360,000,000 in actual cash sales during the two year operation of the scheme. Of this amount, approximately $353,000,000 was from the sale of membership plans and $6,600,000 was from the sale of VoIP Packages. Even more remarkably, seventy-seven percent (77%) of these sales occurred in the six weeks before the filing in a belated attempt by the Debtors to fix their fatally flawed plan by ostensibly requiring the sale of VoIP Packages to receive bonuses and commissions in the future.

68. By and large, the few VoIP Packages that were sold were not used. Of the $6,600,000 in VoIP Package cash sales, less than one percent (1%) of available minutes

[7] While certain commissions required activation of VoIP Packages in a Participant's downline, this requirement was circumvented by the purchase of VoIP Packages with accumulated credits. Credits were also issued for the sale of standalone VoIP Packages but, as discussed above, VoIP Packages were rarely sold to third parties.

contained in these packages were actually utilized, further demonstrating that the Debtors were not operating a bona fide MLMP and the VoIP Packages were not a legitimate product.[8]

69. A pyramid scheme exists where payments to participants are based upon recruitment of additional participants, largely or wholly unrelated to product sales. *See Webster*, 79 F.3d at 782 (MLMP which is based principally on recruitment of new participants, as opposed to sale of the end product or service, and where product sales are an insignificant portion of the enterprise's total revenues, constitutes a pyramid scheme); *Gold Unlimited, Inc.*, 177 F.3d at 481 (company grossed $552,620 from sales of products yet took in $43,000,000); *Stull v. YTB Int'l, Inc.*, 2011 WL 4476419, at *5 (S.D. Ill. Sept. 26, 2011) (approximately 73% of cash receipts were from membership fees and not from the sales of product); *Federal Trade Commission v. Burnlounge, Inc.*, 753 F.3d 878, 888 (9th Cir. 2014)(existence of negligible amount of sales unrelated to commission opportunity does not negate evidence that commissions were the primary draw of the scheme); *In re Holiday Magic, Inc.*, 84 F.T.C. 748, 1028-30 (1974)(pyramid scheme existed where rewards were paid to participants when they recruited others, and recruits also had to purchase product).

70. The total reliance on the sale of membership plans, as opposed to the sale of a legitimate product, made the collapse of the Debtors' scheme inevitable, which is perhaps the chief hallmark of a Ponzi/pyramid scheme. *Webster*, 79 F.3d at 781; *United States v. Grasso*, 173 F. Supp. 2d 353, 357 (E.D. Pa. 2001)(all Ponzi and pyramid schemes are destined to collapse

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[8] This estimate is based upon joint usage of the Debtors' and Ympactus' VoIP service for the period July 2012 through June 2013 as well as usage of only the Debtors' VoIP service from July 2013 to April 2014. Ernst & Young ("E&Y"), the consultants retained by the court in the Brazilian action, made similar findings as to use of the VoIP Packages. As part of its 220 page report issued in February 2015, E&Y also found that for the period July 2012 to June 2013, less than one percent of total VoIP Package minutes sold were actually used.

because of saturation which is the point at which investments by later participants are inadequate to sustain the scheme).

71. A calculation of the Debtors' twelve month trailing liability, that is, the amount that would be owed to Participants in the following year on account of the guaranteed return, further evidences the unsustainability of the scheme. This liability grew exponentially in the year prior to the Petition Date, eventually rising to more than $5,000,000,000 as of the Petition Date. Attached as Exhibit 2 to the *Darr Affidavit* is a computation of the 12 month trailing liability as of the Petition Date. This trailing liability more than tripled in the five (5) months leading up to the Chapter 11 filings, far outpacing any cash generated from the sale of VoIP Packages.[9] The $5,000,000,000 trailing liability is more than seven hundred times the $6,600,000 in cash receipts from the sale of VoIP Packages since inception of the Debtors' MLMP. The sale of additional membership plans only deepened the insufficiency.[10] The unsustainability of the Debtors' MLMP is another hallmark of a Ponzi and pyramid scheme. *See Kerrigan v. ViSalus, Inc.*, 2015 WL 3679266, at *8 (E.D. Mich. June 12, 2015); *Webster*, 79 F.3d at 782; *People v. Sweeney*, 228 Cal. App. 4th 142, 152 (Oct. 15, 2014); *see also Wiand v. Lee*, 753 F.3d 1194, 1201 (11th Cir. 2014)(fact that compensation under an MLMP is almost completely dependent upon membership fees paid by new participants, and not from product sales, is a hallmark of a Ponzi/pyramid scheme).

[9] While one provision of one version of the Participant contracts ostensibly did not require the Debtors to redeem VoIP Packages issued to Participants, this contractual provision is completely undermined by the unequivocal statements in marketing materials and the Debtors' actual practice of paying the guaranteed return on investment without the need to sell any product.

[10] In its report, E&Y similarly found that the TelexFree MLMP was unsustainable. E&Y prepared income and loss projections for TelexFree over a thirty-six (36) month period using various assumptions. The projections reflect that under each set of assumptions, the projected payouts exceed projected revenue from the sale of product, in many instances by $4,000,000,000 to $5,000,000,000 over the 36 month term.

III. BECAUSE THE DEBTORS OPERATED A PONZI/PYRAMID SCHEME, CLAIMS FOR ACCUMULATED CREDITS SHOULD BE DISALLOWED.

72. The accumulated credits held by Participants in their User Accounts as of the Petition Date should not form the basis of allowed claims in these cases.

73. Claims based on the accumulated credits should be disallowed because, in a Ponzi/pyramid scheme, investors who had no knowledge that the scheme was fraudulent are generally entitled to a claim only for the net amounts invested in the scheme and not for fictitious profits.[11] *See In re Bernard L. Madoff Inv. Sec. LLC*, 654 F.3d at 242; *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); c*ompare 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. at 232; *with Bayou I* at 637-38; *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. 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*").

74. Innocent investors have claims against Ponzi/pyramid schemes based in tort under the theories of rescission and restitution for the amounts they were fraudulently induced to invest. *Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995); *Bayou II* at 309; *see also In re Int'l Mgmt. Assoc., LLC, et al.*, 2009 WL 6506657 at *9 (Bankr. N.D. Ga., Dec. 1, 2009). These

[11] This motion seeks a determination that accumulated credits as of the Petition Date should not be considered in calculating allowed claims. Aside from the disallowance of credits, the transactions that should be included in the calculation of Participants' allowed claims in these cases will be subject to separate determination of the Court.

tort claims should be reduced by amounts the Participants received from the scheme. *See In re M & L Bus. Mach. Co.*, 84 F.3d 1330, 1341 (10th Cir. 1996); *In re United Energy Corp.*, 944 F.2d 589, 595 (9th Cir. 1991); *In re Bernard L. Madoff Inv. Sec. LLC,* 424 B.R. 122 (Bankr. S.D.N.Y. 2010).

75. Innocent investors in a Ponzi/pyramid scheme should not have a claim for interest or profits beyond their initial investment because such claims are based on the fictitious profits of the scheme. *BLMIS I* at 427-29; *BLMIS II* at 47; *Scholes* 56 F.3d at 757.

76. The accumulated credits based on the posting of meaningless 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 at 1341.

77. 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).

78. While value arguably may be provided by an innocent third party providing legitimate services to a Ponzi/pyramid operator for a reasonable fee, such is not the case here. Rather, credits that were issued to Participants for recruiting others into the scheme only

perpetuated it and deepened the pool of defrauded investors. *Compare In re Churchill Mortgage Inv. Corp.*, 256 B.R. at 682; *First Commercial Mgmt Grp.*, 279 B.R. at 232; *with Bayou I* at 637-38; *Randy*, 189 B.R. at 438-39; *In re Int'l Loan Network, Inc.*, 160 B.R. at 12; *see also* Janvey, 780 F.3d at 641.

79. 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, 11 S.Ct. 2150, 2155 (1991); *In re Muller*, 479 B.R. 508, 515 (Bankr. W.D. Ark. 2012).

80. Claims based on the accumulated credits should also be disallowed on equitable grounds, which are applicable in resolving claims allowance and distribution issues in Ponzi and pyramid scheme cases. *See Cunningham v. Brown*. 265 U.S. 1(1924); *Abrams v. Eby (In re Young)*, 294 F. 1, 4 (4th Cir. 1923); *In re Taubman*, 160 B.R. at 980; *Int'l Loan Network*, 160 B.R. at 14; *BLMIS II* at 47.

81. Equity requires the disallowance of claims for accumulated credits because these credits could only be satisfied from amounts paid by later Participants and not from earnings of the enterprise or from the sale of product. *See In re Taubman*, 160 B.R. at 980; *BLMIS I* at 427-29.

82. In reality, there are no profits to be paid out of such a scheme. *In re Young*, 294 F. at 4. As one court put it, "if a person invests money with the understanding that he will share in the profits produced by his investment, and it turns out that there are no profits, it is difficult to see how that person can make a claim to receive any more than the return of his principal investment." *Lustig v. Weisz & Assoc., Inc.*, 2002 WL 32500567 at *8 (June 21, 2002 W.D.N.Y.).

83. When a Ponzi or pyramid scheme collapses, insufficient funds remain to make distributions to later investors equal to the principal amounts they invested, such that recognition of claims for false profits would be inequitable to investors who have not and will not recover their principal investment. *In re Taubman*, 160 B.R. at 980.

84. 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 the credits. *See In re Young*, 294 F. at 4 (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).

85. Accordingly, any claim or portion of claim of Participants based upon the accumulated credits in Participants' User Accounts as of the Petition Date should be disallowed.

IV. COMPUTATION OF NET ALLOWED CLAIM OF PARTICIPANTS

86. 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,* 265 U.S. at 13 (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 based upon a "Net Equity" analysis, that is, the allowed claim is equal to amounts that a participant paid into the scheme, reduced by amounts a participant 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, 616-17 (M.D. Fla. 2002). The transfers between a Participant and the Debtors must therefore comprise one component of the Net Equity determination.

87. 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 Investment Fund Ltd.*, 397 B.R. at 8; *Eberhard* 530 F.3d at 132 n.7; *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. *See e.g. Whole Living*, 344 F. Supp. at 745. The Debtors created an artificial currency in the form of the VoIP Packages and credits. The principal vehicle for monetizing those credits was through the recruitment of Participants and the implementation of Triangular Transactions. Accordingly, the Triangular Transactions need to be taken into account in determining Net Equity.

88. In determining Net Equity, the recruited Participant should have a claim recognized in the bankruptcy cases for the amounts advanced to a recruiting Participant in a Triangular Transaction. Recognition of this claim is necessary to achieve an equitable result. A substantial number of those who joined the Debtors' scheme did so through participation in Triangular Transactions. The claims of these Participants should be treated the same as the

claims of Participants who paid their membership fees to the Debtors. Those later Participants who invested in the Debtors through Triangular Transactions were often at the bottom of the pyramid and were the least likely to know of the suspect nature of the Debtors' scheme. Equitable considerations require recognition of those claims to achieve a just result. *Cunningham,* 265 U.S. at 13.

89. Recognition of the claim of the later Participant in a Triangular Transaction necessitates that the claim of the earlier Participant be reduced for amounts paid to him/her by the later Participant. Otherwise, the Triangular Transaction would result in an increase in aggregate claims against the Debtors' estates even though the membership fees were retained by the recruiting Participant. If the recruiting Participant's claim is not so reduced, the calculation of the recruiting Participant's Net Equity will be overstated, thereby diminishing the recovery for other Participants. This obviously results in an inequitable outcome, perverts the distribution process, and disregards the mechanics of the scheme.

90. 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 there should be no claim in the bankruptcy estate on account of them. The Participant's claim for the purchase of a membership plan in one User Account will be offset by the reduced claim in the other User Account.

91. Recognizing the claim of later Participants and reducing the claim of earlier Participants reflects the economic realities of the Triangular Transactions. 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).

92. The collapsing of transactions into an integrated transaction has been employed in varying contexts. 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 not paid directly by the debtors. *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, 107 S. Ct. 3229 (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. 2011). Similarly, payments made by a purchaser of a debtor's assets to certain of the debtor's creditors are considered to have been made from property of the estate when the payment would have otherwise been part of the purchase price for the assets. *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.

93. Collapsing the Triangular Transactions into one justifies the inclusion of the Triangular Transactions in the determination of Net Equity because the membership fees exchanged between Participants constituted property of the estate. The definition of property of

the bankruptcy estate is broad, encompassing all legal or equitable interests of the Debtors in property as of the commencement of the case. *See 11 U.S.C. §541; United States v. Whiting Pools Inc.*, 462 U.S. 198, 205 n. 9 (1983); H.R. Rep. No. 95-595 p. 367 (1977); S. Rep. No. 95-989, P. 82 (1978), U.S. Code Cong. & Admin. News 1978, pp. 5869, 6323. In the Triangular Transaction, the later Participant effectively paid the membership fee to the Debtors and the Debtors became liable to the later Participant for the guaranteed return. For the reasons set forth, the later Participant should have a claim in the bankruptcy cases for the amount of the membership fee. The Debtors, in turn, effectively paid the membership fee to the recruiting Participant in exchange for the redemption of credits. This payment by the Debtors to the recruiting Participant requires the reduction of the recruiting Participant's claim. To the extent recruiting Participants received more from the scheme than they invested, the Bankruptcy Code's avoidance actions provide the method to ensure equality of distribution among Participants.

94. Based upon the foregoing, the Net Equity claim of Participants should be determined as follows: the amount invested by the Participant into the Debtors' scheme, including amounts paid by the Participant pursuant to the Triangular Transactions, less amounts received by the Participant from the Debtors' scheme, including amounts received by the Participant pursuant to the Triangular Transactions.

95. The Net Equity determination will be made on a User Account basis. Many Participants appear to have maintained multiple User Accounts. In these circumstances, determination of the Net Equity for a Participant will require an aggregation of the transactions for such Participant in all of his/her User Accounts to ensure that all activity associated with that Participant has been accounted for.

V. THE DEBTORS ARE JOINTLY LIABLE FOR PARTICIPANT CLAIMS

96. The Debtors worked in concert with one another to develop, market, and operate their Ponzi and pyramid scheme. The Debtors had common ownership and each was controlled by Wanzeler and Merrill, as well as Carlos Costa at least through his alleged separation from the Debtors in the fall of 2013.

97. Each of the Debtors was intimately involved in the scheme. Common Cents Communications, Inc., which was owned and controlled by Wanzeler, Merrill, and Steven Labriola, changed its name to TelexFree, Inc. in early 2012 in conjunction with the marketing and selling of VoIP Packages through the Debtors' MLMP. Shortly thereafter, in July 2012, TelexFree, LLC was formed, to conduct TelexFree's operations outside of Massachusetts.

98. TelexFree, Inc. and TelexFree, LLC worked collaboratively in furtherance of the scheme throughout 2012 and 2013, including joint marketing efforts, promotional materials, and Participant recruitment events. TelexFree, Inc. and TelexFree, LLC alternated responsibility for maintaining bank accounts, because on multiple occasions TelexFree was asked to close accounts with banks because of suspicious account activity.

99. The concerted actions of the Debtors in developing, marketing, and operating the Ponzi and pyramid scheme renders them jointly and severally liable for the claims of Participants. *See Aetna Cas. Sur. Co. v. P&B Autobody*, 43 F.3d 1546, 1564 (1st Cir. 1994)(joint tortfeasors can be vicariously liable for the acts of one another if there exists concerted action to commit the torts; liability requires first, "a common design or an agreement between two or more persons to do a wrongful act and, second, proof of some tortious act in furtherance of the agreement." *Id.; Restatement (Second) of Torts §876 cmt. b (1977).*

100. After the seizure and shutdown of Ympactus by the Brazilian authorities, TelexFree, LLC and TelexFree, Inc. saw a substantial increase in activity, which further exacerbated difficulties with banking facilities needed to conduct the TelexFree scheme. TelexFree Financial, Inc. was formed in Florida in December 2013 and opened bank accounts and paid expenses of TelexFree, Inc. and TelexFree, LLC. In late 2013, TelexFree, Inc. and TelexFree, LLC transferred more than $4,000,000 to an account at TelexFree Financial. TelexFree Financial deposited an additional $10,000,000 in membership fees and VoIP Package sales in February 2014. The only Debtor with employees was TelexFree, Inc. and these employees were being paid by TelexFree Financial.

101. TelexFree Financial rendered substantial assistance to TelexFree, LLC and TelexFree, Inc. in furtherance of the Ponzi and pyramid scheme and is therefore also jointly liable to Participants as a joint tortfeasor. *See Kurker v. Hill,* 44 Mass. App. Ct. 184, 189 (Mass. App. 1998)(joint tortfeasor liability, also referred to as civil conspiracy, arises when a party knows that the "conduct [of another person] constitutes a breach of duty and gives substantial assistance or encouragement to the other to so conduct himself." TelexFree Financial, being under common ownership with TelexFree, LLC and TelexFree, Inc. had full knowledge of the actions being perpetrated by the other Debtors. *Kurker*, 44 Mass. App. Ct. at 189*; Kyte v. Philip Morris Inc.*, 408 Mass. 162 (1990); *Stock v. Fife*, 13 Mass. App. Ct. 75, 82 (Mass. App. 1982)(key to joint tortfeasor liability is the rendering of substantial assistance, with the knowledge that such assistance is contributing to a common tortious plan.)

102. The Debtors had a common design or agreement to commit a wrongful act, which was the establishment and implementation of the Ponzi and pyramid scheme. Because the

Debtors engaged in a common enterprise to further their tortious plan, the Debtors are jointly and severally liable for the allowed claims of Participants.

103. Inasmuch as the Debtors are jointly and severally liable for the claims of Participants, the Bar Date Motion proposes that Participants submit only one Participant ePOC, which shall constitute a claim against all three of the Debtors' estates. The Bar Date Motion does propose that non-Participants file a separate Standard ePOC for each Debtor against whom a claim is asserted.

104. A finding of joint and several liability for the claims of Participants does not effect a substantive consolidation of the Debtors' estates. Grounds may exist for the Trustee to seek substantive consolidation of the Debtors' estates and the Trustee reserves the right to seek same. In the event of substantive consolidation, Participants having submitted a Participant ePOC will have a single claim against the consolidated estate.

V. NOTICE

105. The Trustee has filed simultaneously herewith the Notice Motion to prescribe the form and manner for providing notice of the Ponzi Motion to interested parties.

WHEREFORE, the Trustee respectfully requests that this Court enter an Order:

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

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

(iii) Ordering that the Debtors shall be jointly and severally liable for the claims of Participants;

(iv) Ordering that the findings made pursuant to this Motion shall be applicable throughout these proceedings, for all purposes; and

(v) Granting such other and further relief as this Court finds just and proper.

STEPHEN B. DARR,
CHAPTER 11 TRUSTEE,

By his attorneys,

/s/ Andrew G. Lizotte

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Dated: October 7, 2015
696114

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**

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

I, Stephen B. Darr, hereby submit the following affidavit in support of 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").

Introduction

1. I am the duly appointed Chapter 11 trustee (the "Trustee") in these cases, having been appointed by order of the Court dated June 6, 2014.

2. I am a Managing Director with the Business Advisory Practice of Huron Consulting Group. I have more than 35 years of experience providing accounting, auditing and financial consulting services to business organizations many of which are experiencing significant financial and operating difficulties. I am a Certified Public Accountant in Massachusetts and New Hampshire, a Certified Insolvency and Restructuring Advisor and hold certifications in both Financial Forensics and Distressed Business Valuation, as well as other professional qualifications.

3. The statements provided herein are based upon information and knowledge I have derived through my involvement in these Chapter 11 cases, as further set forth herein.

4. During the course of my investigative duties in these cases, my colleagues and I have examined the Debtors' books and records that were seized from the Debtors by federal authorities, electronic copies of which were provided to me, as well as documents produced by third parties in response to numerous motions for Federal Rule of Bankruptcy Procedure 2004 examinations. I and my professionals have conducted interviews of the Debtors' former employees and consultants, as well as professionals retained by the Debtors during the Chapter 11 cases. I have also reviewed the docket in these cases.

I. CASE BACKGROUND AND PROCEDURAL POSTURE

5. On April 13, 2014 (the "Petition Date"), each of TelexFree, Inc., TelexFree, LLC, and TelexFree Financial, Inc. (collectively, 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").

6. The Debtors initially operated as debtors-in-possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code.

7. On the Petition Date, the Debtors filed a motion for joint administration of the cases, with TelexFree, LLC designated as the lead case. By order dated April 24, 2014, the order for joint administration was approved.

8. Prior to the filings, the Commonwealth of Massachusetts, Office of Secretary of State, Securities Division ("MSD") commenced an investigation into the Debtors' business practices.

9. 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 ("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/pyramid scheme and the fraudulent and unregistered offering of securities. Substantially 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 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.

10. On or about April 22, 2014, the Office of the United States Trustee filed a motion for the appointment of a Chapter 11 Trustee based upon the allegations of illegal activity.

11. On April 23, 2014, the SEC filed a motion to transfer venue of the cases to the United States Bankruptcy Court for the District of Massachusetts (the "Court"). By order dated May 6, 2014, the motion to change venue was approved. The cases were transferred to the Court on May 9, 2014.

12. On May 30, 2014, this Court allowed the United States Trustee's motion to appoint a Chapter 11 trustee, and I was appointed on June 6, 2014.

13. The Debtors filed only a list of the alleged thirty (30) largest creditors in the cases and did not file schedules or statements of financial affairs, nor a matrix of creditors.

14. On February 27, 2015, I filed schedules of assets and liabilities and statements of financial affairs for each of the Debtors, using information obtained from documents produced pursuant to Rule 2004 examinations and Debtor records provided by the Federal Authorities (as defined below).

15. Carlos Wanzeler and James Merrill were the Debtors' principals along with Carlos Costa, at least through his alleged separation with the Debtors in the fall of 2013. Shortly after the Trustee was appointed, the United States Department of Justice ("DOJ" and, together with the SEC and HSI, the "Federal Authorities") indicted Wanzeler and Merrill based upon their involvement in the Debtors' scheme. Wanzeler has fled the country and, upon information and belief, is in Brazil. Merrill was initially detained and has been released pending trial.

16. On February 3, 2015, I submitted a comprehensive Status Report on outstanding matters in the cases. The Status Report set forth, among other things, the background of the Debtors and their affiliates, the breadth and scope of the scheme, assets recovered to date and potential additional sources of recovery, as well as efforts at coordination with governmental authorities, both in the United States and in Brazil.

17. Prior to my appointment, the Federal Authorities shut down, disconnected, and seized the Debtors' computer system, which consisted of forty-six (46) computers and servers containing more than twenty (20) terabytes of data. Accordingly, at the time of my appointment, I did not have access to any of the Debtors' records. Neither of the Debtors' principals has been available because Wanzeler fled the country and Merrill had been indicted and detained. I have had only had limited access to the Debtors' former employees.

18. Initially without access to the Debtors' books and records, I have utilized a variety of resources to acquire information regarding the Debtors' activities and the mechanics of their scheme.

19. I directed counsel to file motions for authority to obtain documents from, and conduct examinations of, twenty-nine (29) separate entities pursuant to Federal Rule of Bankruptcy Procedure 2004 (the "2004 Motions").[1] The deponents of the 2004 Motions included prepetition and postpetition professionals retained by the Debtors, financial institutions who had prepetition and/or postpetition relationships with the Debtors, multiple firms who provided payment processing services to facilitate payments between the Debtors and Participants, and firms who provided consulting services to the Debtors or who otherwise were believed to have had business relationships with the Debtors.

20. I have also conducted or supervised informal interviews of certain former employees and consultants of the Debtors as well as several Participants.

A. Mechanics of Scheme and Methods of Compensation

21. The Debtors purported to be in the business of selling a voice over internet service, or "VoIP" that cost $49.90 per month to conduct international phone calls. The sale of VoIP on a monthly basis is hereinafter referred to as a "VoIP Package". Customers who purchased the VoIP Package registered their phone numbers with the Debtors and received software that enabled their computers to place phone calls through the Debtors' computer servers in Marlborough, Massachusetts to approximately 40 countries.

22. The Debtors ostensibly used a multi-level marketing plan, or "MLMP", to sell the VoIP Packages.

[1] To date, I have deferred conducting depositions of the 2004 Motion deponents, as the focus has been on retrieving and examining documents and conducting informal interviews.

23. Until they purported to change their MLMP in March 2014, the Debtors provided Participants with two options to become members and to thereby open User Accounts:

a. "AdCentral Plan": $339 for a one-year contract ($50 membership fee plus $289 contract fee). This contract entitled the User Account holder with the right to sell ten VoIP Packages, as to which a Participant could receive a commission if the packages were sold, although there was no sale requirement. Participants were required to place one internet ad per day and, for each week in which the Participant placed the required ads, he/she was entitled to one additional VoIP Package, which could be sold or exchanged for $20 in credits with the Debtors. Thus, Participants who posted the required ads were eligible to receive $20 per week for 52 weeks, for a total return of $1,040 (a return of 207% on the investment of $339).

b. "AdCentral Family Plan": $1,425 for a one-year contract ($50 membership fee plus $1,375 contract fee). This contract entitled the User Account holder with the right to sell fifty VoIP Packages, as to which a Participant could receive a commission if the packages were sold, although there was no sale requirement. Participants were required to place five internet ads per day and, for each week in which the Participant placed the required ads, he/she was entitled to five additional VoIP Packages, which could be sold or exchanged for $100 in credits with the Debtors. Thus, the Participants who posted the required ads were eligible to receive $100 per week for 52 weeks, for a total return of $5,200 (a return of 265% on the investment of $1,425).

24. In addition to credits for posting these advertisements, the Debtors issued credits to Participants for the sale of membership plans and the establishment of new User Accounts as follows:

a. $20 in credits for each new Ad Central Plan and $100 in credits for each new AdCentral Family Plan in a Participant's network.

b. $20 in credits for each User Account in one's "network," up to a maximum of $440, as long as there were two subsidiary User Accounts.

c. 2% of all payments to each User Account within one's network, down to six "levels" of the network, provided that each User Account had a registered VoIP customer.

d. 2% of the Debtors' net monthly billing, up to a maximum of $39,600 in credits, for an AdCentral Family Plan that had ten new AdCentral Family

Plans in its network, so long as each plan had five registered VoIP customers.

25. The Debtors also issued credits to Participants for the sale of VoIP Packages as follows:

a. 90% (or $44.90 in credits) for the initial sale of a VoIP Package at $49.90.

b. 10% (or $4.99 in credits) per month for the renewal of a VOIP Package by a User Account holder directly in one's network[2] and 2% (or $0.99 in credits) per month for the renewal of a VOIP Package by a User Account holder indirectly in one's network, down to six levels of the network.

c. 2% from all VoIP Package sales in one's network, down to six levels of the network.

26. The credits issued to Participants for placing advertisements and selling membership plans and VoIP Packages could be redeemed for cash, transferred to another User Account, or applied in satisfaction of an invoice for another User Account.

27. Invoices for the purchase of a membership plan could be satisfied in one of two ways. Participants could pay the invoice in cash directly to the Debtors or Participants could pay a recruiting Participant for the purchase of a membership plan through the recruiting Participant's redemption of credits in an existing User Account.

28. In the case of a Participant satisfying his/her own invoice directly by payment in cash to the Debtors, the process worked, generally, as follows:

a. The Participant joined the Debtors' organization and created an online account with the assistance of a recruiting Participant, who needed to be identified;

b. The Debtors' database recorded the details entered by the new Participant and assigned an identification number to the new User Account;

c. The Debtors recorded the purchase, issued an invoice number, and marked the invoice as 'pending';

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[2] In practice, the Debtors appear to have provided Participants with credits equal to ninety percent (90%) of the renewal fees.

d. A Participant could pay money directly to the Debtors in the form of cash, check, cashier's check, or wire transfer, or through a third-party online payment processing account. Once the Participant paid the invoice, the Debtors updated the invoice as 'paid', and the account setup would be complete;

e. The new Participant could then start building a pyramid underneath the newly created User Account by recruiting other Participants (or by purchasing new User Accounts themselves) and generating bonuses and commissions in accordance with the scheme.

29. Alternatively, as described below, a Participant could satisfy his/her own invoice directly by payment in cash to another Participant, who would satisfy the invoice by a redemption of accumulated credits. Thus, the new Participant's membership fee was paid directly to the recruiting Participant, rather than to the Debtors.

30. There are 10,987,617 User Accounts associated with the Debtors' MLMP. A new User Account was generally established each time that a membership plan was purchased, with either cash or accumulated credits.

31. Although some versions of Participant contracts contained prohibitions against Participants opening multiple User Accounts, other plan descriptions did not. In any case, any such restriction was not enforced and could not be enforced since the Debtors did not verify the Participants' identities. The Debtors' MLMP structure created incentives for Participants to open multiple User Accounts to generate commissions for themselves.

32. As noted above, a Participant could monetize accumulated credits by recruiting a new Participant to join the Debtors' scheme 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 (a "Triangular Transaction"). In a Triangular Transaction, the Debtors issued the membership invoice to the recruited Participant, the recruited Participant paid

the membership invoice that was due to the Debtors instead to the recruiting Participant, and the Debtors redeemed the credits of the recruiting Participant in satisfaction of the invoice.

33. In a Triangular Transaction, the process generally worked in the same manner outlined above except that:

a. The new Participant paid the invoice amount to the recruiting Participant (in those cases where there were two separate Participants involved, that is, not an intra-Participant transaction) and forwarded the initial invoice to the recruiting Participant; and

b. The recruiting Participant, in turn, satisfied the initial invoice with accumulated credits in his/her existing User Account.

34. In fact, it was a regular practice of the Debtors' scheme for membership fees to be paid by the use of accumulated credits rather than by cash.

35. While invoices associated with the sale of membership plans or VoIP Packages had a face value of $3,073,471,326, only $359,792,242, or approximately twelve percent (11.7%) of that amount, was paid in cash to the Debtors. The balance of these invoices, totaling $2,713,679,084, was satisfied by the use of Participants' credits.

36. The Debtors also issued "manual credits" to certain User Accounts in some instances. Manual credits were credits issued to User Accounts unrelated to the purchase of a membership plan and not resulting from the placement of advertisements or other components of the compensation scheme. Although some manual credits may have been issued to User Accounts in exchange for cash payment to the Debtors, a significant amount of manual credits appear to have been issued to certain User Accounts without any payment to the Debtors. There also were exchanges of credits between User Accounts unassociated with the issuance and satisfaction of Debtor invoices.

B. SIG/Back Office

37. The Debtors maintained two computer applications for accessing and processing information from the Debtors' database relating to User Account activity, referred to as "SIG" and the "Back Office".[3]

38. SIG stands for Sistemas de Informacoes Gerenciais, which is Portuguese and translates roughly to "Information Management System." SIG tracked the activity for Participants by User Account, and the User Accounts are the only records available to confirm Participant activity.

39. Access to SIG was the culmination of a painstaking data recovery and analysis project implemented with the assistance of my professionals and investigators from HSI.

40. Following my appointment and beginning in August 2014, HSI provided copies of electronic information contained in the Debtors' computers and servers. Once all of the data from the Debtors' computers and servers were obtained, I and my team reassembled the system following a multiple step process.

41. The first step involved identification of a key server that appeared to contain much of the Debtors' 'big data'. Extensive testing was then performed to determine the appropriate configurations of the data and to restore the data in a virtual machine environment. Once the physical configuration of the hard drives was determined, the servers were 'virtualized', which was necessary because the Federal Authorities were in possession of the original servers. Additional servers were later identified that were necessary to operate the network. Once the key components of the system were identified and operating, passwords were obtained through research into document productions received, communications with Federal

[3] The Back Office was the program used by Participants to obtain information on their User Account activity.

Authorities, and a variety of investigative tools. Finally, an intensive analysis was performed to better understand the database structure, table relationships, data fields, and process flow.

42. Once access to a working version of SIG was obtained, I and my professionals were able to conduct search queries and sort data. Because SIG was complicated, written in more than one language, and poorly maintained, and system documentation was unavailable, substantial additional hurdles remained to achieving an understanding of the system and extracting usable data.

43. The Debtors' database was developed by programmers in Brazil and all field references are in Portuguese. System modifications appear to have been done in a haphazard and disorganized fashion. The Debtors' system is permeated with unreliable data because of limited efforts at data validation in establishing User Accounts.

44. Despite all of these obstacles, as a result of the forensic efforts identified above, I and my team have been able to reconstruct the Debtors' computer system in a virtual environment and obtain a working understanding of SIG and how it was used to track User Account activity.

45. Each time that a Participant purchased a membership plan or VoIP Package, an account was established with SIG (the "User Account").

46. Each User Account with the Debtors was registered with an electronic mail address ("Email Address"). There are approximately 900,000 unique Participant Email Addresses in SIG associated with 10,987,617 User Accounts. The number of User Accounts associated with an Email Address varies widely. A particular Email Address may be associated with a single User Account or may be associated with hundreds or thousands of User Accounts. Because each User Account may represent a separate Participant and some Participants entered

the scheme using the Email Address of another Participant, the number of Participants is unknown but is likely to be well in excess of 1,000,000.

47. After a User Account was established, SIG tracked the activity of the Participant in that User Account, including the accumulation of credits for bonuses and commissions 'earned', the use or transfer of credits between User Accounts, and payments made to or from the Participant directly with the Debtors.

48. SIG contains more than 100 tables of data. These tables include an Account Table (which contains a unique record for each User Account), an Invoice Table (which contains a unique record of each invoice generated by the Debtors), a Transfer Table (which contains information about each transfer of credits within the TelexFree system, including withdrawals of funds), and a Bonus Table (which contains information about each increase in credits into a User Account).

49. I and my advisors have taken a series of steps to confirm the accuracy and reliability of the transaction data reflected in SIG. My advisors interviewed the Debtors' bookkeeper, Andrea Cabral, to understand the mechanics of SIG and how it was employed on a day to day basis. Limited testing was performed to reconcile balances and activity using available data, including cross-referencing data in related transactions, conducting interviews with several Participants to confirm the accuracy of the SIG data as to their User Accounts, and reconciling payment data with third party processor records. Based on the testing performed to date, SIG provides accurate information regarding membership plan sales, issuance of invoices, accumulation and use of credits, and amounts received from and disbursed to the User Accounts.

C. Relationship with Ympactus, and Segregation of Ympactus Information and Debtor Information

50. In February 2012, Ympactus commenced operations in Brazil and reportedly operated a scheme substantially identical to the scheme that is described above. The Debtors commenced operations in April 2012. Ympactus initially grew much more rapidly than the Debtors, with growth accelerating in the fall of 2012 through the early summer of 2013. By the spring of 2013, Ympactus had cash receipts of more than $100,000,000 per month. *See Exhibit "1"*. On the other hand, the Debtors' cash receipts were initially much more modest. In the spring of 2013, the Debtors' cash receipts averaged approximately $6,400,000 per month. *See Exhibit "1"*.

51. On June 28, 2013, the Public Prosecutor's Office of the State of Acre, Brazil filed claims against Ympactus, Carlos Wanzeler, Lyvia Mara Campista Wanzeler, and James Merrill, alleging that the VoIP Packages marketed in Brazil were violating consumer rights, since the MLMP constituted a Ponzi/pyramid scheme. The Brazilian authorities suspended the operations of Ympactus and froze its assets in Brazil. Upon information and belief, the Brazilian authorities seized as much as $300,000,000 from Ympactus in connection with the shutdown, and civil and criminal proceedings are pending in Brazil. On or about September 21, 2015, the Brazilian court entered a decision finding that Ympactus operated a pyramid scheme.

52. Following the shutdown of Ympactus, the Debtors' cash receipts increased dramatically. The Debtors' cash receipts totaled approximately $198,500,000 in the last three full months of operation, with more than $96,600,000 in cash receipts in February 2014 alone. *See Exhibit "1"*.

53. The SIG system maintained by the Debtors and Ympactus ran off a single database reflecting User Account activity for both operations. After reconstructing the computer

network and developing a working understanding of SIG, one of the first tasks was to determine how to segregate the Debtors' activity from that of Ympactus, since SIG did not clearly differentiate the User Accounts between the two.

54. SIG includes 17,016,780 distinct User Accounts associated with 2,166,955 Email Addresses for both the US-based and the Brazilian-based operations.

55. I believe that a valid basis exists to separate the Debtors' User Account data based upon the currency designation in the data fields.

56. The Debtors' system assigned a currency to be used to pay invoices based on the Participant's country of residence. Participants entering Brazil as their home address paid invoices denominated in Brazilian Reais ("Reais") and all others paid invoices denominated in United States Dollars, although for accounting purposes, all transactions in the database were recorded in United States Dollars. The Invoice Table distinguishes between invoices paid in United States Dollars and invoices converted to United States Dollars from Reais.

57. The Invoice Table contains a "cambio" or "exchange rate" field. In 99.7% of transactions, by amount, where the currency field is denominated as "D" or United States Dollars, the cambio field is populated with a "0". In 99.8% of the transactions where the currency field is denominated as "R" or Brazilian Reais, the cambio field is populated with a range of values from 1.98 to 2.37 (that is, 1.98 to 2.37 Reais for each 1 Dollar). I have confirmed that the two currencies traded in this conversion range during the time that the Debtors and Ympactus were simultaneously in operation.

58. Through a review of the currency field data, I have further determined the following:

a. Prior to the shutdown of Ympactus in June 2013, invoices in User Accounts with Brazilian contact information were denominated in Reais and invoices in User Accounts with non-Brazilian contact information were denominated in Dollars;

b. Fewer than 700 Reais-denominated User Accounts were associated with non-Brazilian addresses. Similarly, fewer than 150 Dollar-denominated User Accounts were associated with Brazilian addresses; and

c. There was relatively little activity after the shutdown of Ympactus for Reais-denominated User Accounts that were created prior to the shutdown, and all cash activity for Reais-denominated accounts ceased shortly after the shutdown.

59. Utilizing the currency designation, 10,987,617 User Accounts are associated with the Debtors' operations and 4,006,422 User Accounts are associated with Ympactus operations. The remaining User Accounts have no activity.

II. FINDING OF EXISTENCE OF PONZI AND PYRAMID SCHEME

60. Participants who purchased the AdCentral Plan became entitled to receive a VoIP Package each week by placing one internet advertisement per day. These VoIP Packages could be, and routinely were, converted into credits for $20 weekly for 52 weeks, for a 207% return on the initial investment of $339. Participants who purchased the more expensive AdCentral Family Plan were entitled to receive five additional VoIP Packages each week by placing five internet advertisements per day. These VoIP Packages could be, and routinely were, converted into credits for $100 weekly for 52 weeks, for a return of 265% on the initial investment of $1,425.

61. The repetitive posting of internet advertisements (which were reportedly supplied by the Debtors) served no legitimate purpose, because anyone who used "telexfree" as an internet search term would be led to the Debtors' own website, and the repetitive posting of similar advertisements had no discernable value. For example, one website, Adpost.com, contained more than 33,000 postings submitted by Participants for TelexFree, while another, ClassifiedsGiant.com, contained more than 25,000 postings

62. Participants did not draft the advertisements or perform any design services for their configuration, and the placing the ads could be, and often was, outsourced to third parties for a nominal fee. The requirement of posting advertisements to receive weekly payments obfuscated the true nature of the scheme – that the credits were a disguised, "guaranteed" return on the Participant's initial investment.

63. The guarantee of an astronomical return on the initial investment without the requirement to sell any product created perverse incentives for Participants. Participants opened multiple User Accounts for the sole purpose of leveraging their fictitious profits, without the need to sell any product or recruit any individuals. Some Participants appear to have invested a substantial portion of their life savings into the scheme seeking to quickly triple or quadruple their investment. Participants opened hundreds of User Accounts, ultimately resulting in an exponential rise in the number of User Accounts.

64. Participants who opened multiple User Accounts on their own behalf could generate credits by essentially recruiting themselves. Participants could receive (1) $20 worth of credits for recruitment of an AdCentral Plan member and $100 in credits for recruitment of an AdCentral Family Plan member, and (2) $20 in credits for each membership plan in one's downline, up to a maximum of $440 in credits, so long as that Participant recruited two new User

Accounts in his/her downline by either opening User Accounts in his/her own name or by recruiting new Participants.

65. While there were certain provisions of the Debtors' MLMP that ostensibly required the sale of VoIP Packages as a requirement for receiving credits, the credits that could be generated for those activities were relatively insignificant and the requirements were easily circumvented by Participants.[4]

66. The Debtors had $359,792,242 in actual cash sales during the two year operation of the scheme. Of this amount, approximately $353,000,000 was from the sale of membership plans and $6,600,000 was from the sale of VoIP Packages. Even more remarkably, seventy-seven percent (77%) of sales occurred in the six weeks before the filing in a belated attempt by the Debtors to fix their fatally flawed plan by ostensibly requiring the sale of VoIP Packages to receive bonuses and commissions in the future.

67. By and large, the few VoIP Packages that were sold were not used. Of the $6,600,000 in VoIP Package cash sales, less than one percent (1%) of available minutes contained in these packages were actually utilized, further demonstrating that the Debtors were not operating a bona fide MLMP and the VoIP Packages were not a legitimate product.[5] Approximately $477,888,000 in VoIP Packages were sold through the use of accumulated credits. Approximately eighty percent (80%) of these sales occurred in the six weeks leading up to the Petition Date in connection with implementation of the new compensation scheme.

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[4] While the generation of certain commissions required activation of VoIP Packages in a Participant's downline, this requirement was circumvented by the purchase of VoIP Packages with accumulated credits. Credits were also issued for the sale of standalone VoIP Packages but VoIP Packages were rarely sold to third parties.

[5] This estimate is based upon information contained in the Disk A Vantage database (which includes VoIP service for both the Debtors and Ympactus) for the period July 2012 through June 2013, as well as usage of only the Debtors' VoIP service for the period July 2013 to April 2014.

68. The total reliance on the sale of membership plans, as opposed to the sale of a legitimate product, made the collapse of the Debtors' scheme inevitable.

69. A calculation of the Debtors' twelve month trailing liability, that is, the amount due to Participants over the following year on account of the guaranteed return, further evidences the unsustainability of the scheme. This liability grew exponentially in the year prior to the Petition Date, eventually rising to more than $5,000,000,000 as of the Petition Date. Attached as *Exhibit "2"* hereto is a computation of the 12 month trailing liability as of the Petition Date. This trailing liability more than tripled in the five (5) months leading up to the Chapter 11 filings, far outpacing any cash generated from the sale of VoIP Packages.[6] The $5,000,000,000 trailing liability is more than seven hundred times the $6,600,000 in cash receipts from the sale of VoIP Packages since inception of the Debtors' MLMP. The sale of additional membership plans only deepened the insufficiency.

IV. THE DEBTORS ARE JOINTLY LIABLE FOR PARTICIPANT CLAIMS

70. The Debtors worked in concert with one another to develop, market, and operate their Ponzi and pyramid scheme. The Debtors had common ownership and each was controlled by Wanzeler and Merrill, as well as Carlos Costa at least through his alleged separation from the Debtors in the fall of 2013.

71. Each of the Debtors was intimately involved in the scheme. Common Cents Communications, Inc., which was owned and controlled by Wanzeler, Merrill, and Steven Labriola, changed its name to TelexFree, Inc. in early 2012 in conjunction with the marketing

[6] While certain provisions of Participant contracts did not require the payment to Participants for VoIP Packages issued to them, this contractual provision is completely undermined by the unmistakable statements in marketing materials and some of the Participant contracts promising Participants the right to a guaranteed return on investment without the need to sell any product.

and selling of VoIP Packages through the Debtors' MLMP. Shortly thereafter, in July 2012, TelexFree, LLC was formed, to conduct TelexFree's operations outside of Massachusetts.

72. TelexFree, Inc. and TelexFree, LLC worked collaboratively in furtherance of the scheme throughout 2012 and 2013, including joint marketing efforts, promotional materials, and Participant recruitment events. TelexFree, Inc. and TelexFree, LLC alternated responsibility for maintaining bank accounts, because on multiple occasions TelexFree was asked to close accounts with banks because of suspicious account activity.

73. After the seizure and shutdown of Ympactus by Brazilian authorities, TelexFree, LLC and TelexFree, Inc. saw a substantial increase in activity, which further exacerbated difficulties with banking facilities needed to conduct the TelexFree scheme. TelexFree Financial, Inc. was formed in Florida in December 2013 and opened bank accounts and paid expenses of TelexFree, Inc. and TelexFree, LLC. In late 2013, TelexFree, Inc. and TelexFree, LLC transferred more than $4,000,000 to an account at TelexFree Financial. TelexFree Financial deposited an additional $10,000,000 in membership fees and VoIP Package sales in February 2014. The only Debtor with employees was TelexFree, Inc. and these employees were being paid by TelexFree Financial.

74. TelexFree Financial rendered substantial assistance to TelexFree, LLC and TelexFree, Inc. in furtherance of the Ponzi and pyramid scheme.

75. The Debtors had a common design or agreement to establish and implement the Ponzi and pyramid scheme. The Debtors engaged in a common enterprise to further their plan.

I attest that, to the best of my knowledge, the foregoing is true and accurate.

Dated: October 7, 2015

Stephen B. Darr
Chapter 11 Trustee

695349

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

Exhibit 1

In re: TelexFree, LLC, *et al.*
Cash Receipts by Month - TelexFree and Ympactus

Month	TelexFree	Ympactus
February 2012	$ 150	$ 22,942
March 2012	1,884	84,503
April 2012	14,709	336,350
May 2012	43,983	1,847,443
June 2012	53,606	4,764,547
July 2012	84,986	8,948,617
August 2012	375,556	15,030,324
September 2012	768,207	34,346,283
October 2012	290,450	12,987,841
November 2012	693,672	34,128,986
December 2012	616,314	55,083,742
January 2013	1,764,966	143,425,971
February 2013	4,972,733	257,513,534
March 2013	3,800,994	121,512,314
April 2013	5,983,150	149,372,999
May 2013	9,467,356	284,144,633
June 2013	13,949,543	184,497,992
July 2013	12,180,176	-
August 2013	18,850,084	-
September 2013	9,279,178	-
October 2013	14,929,643	-
November 2013	27,738,566	-
December 2013	33,310,766	-
January 2014	48,483,827	-
February 2014	96,630,356	-
March 2014	53,385,849	-
April 2014	2,121,537	-
	$ 359,792,242	$ 1,308,049,021

Note: Determination of TelexFree vs. Ympactus based on Invoice Table data as described in Darr Affidavit.
Source: Debtors' Participant database.

Exhibit 2

In re: TelexFree, LLC, *et al.*

Trailing Liability Calculation - Advertising Bonus[1,2,3]

Trailing Liability	Outstanding ADCentral Payments	Outstanding ADCentral Family Payments	ADCentral Liability ($20 per week)	ADCentral Family Liability ($100 per Week)	Total Liability
February 2012	$ -	$ -	$ -	$ -	$ -
March 2012	-	-	-	-	-
April 2012	-	-	-	-	-
May 2012	-	102	-	10,200	10,200
June 2012	-	1,871	-	187,100	187,100
July 2012	-	2,881	-	288,100	288,100
August 2012	-	5,659	-	565,900	565,900
September 2012	1,237	5,735	24,740	573,500	598,240
October 2012	5,640	20,526	112,800	2,052,600	2,165,400
November 2012	9,989	39,832	199,780	3,983,200	4,182,980
December 2012	19,484	94,394	389,680	9,439,400	9,829,080
January 2013	31,697	182,875	633,940	18,287,500	18,921,440
February 2013	78,520	356,527	1,570,400	35,652,700	37,223,100
March 2013	164,655	506,542	3,293,100	50,654,200	53,947,300
April 2013	283,453	761,101	5,669,060	76,110,100	81,779,160
May 2013	494,359	1,261,216	9,887,180	126,121,600	136,008,780
June 2013	739,166	1,798,677	14,783,320	179,867,700	194,651,020
July 2013	1,096,143	2,411,703	21,922,860	241,170,300	263,093,160
August 2013	1,684,888	3,656,684	33,697,760	365,668,400	399,366,160
September 2013	2,559,676	5,852,955	51,193,520	585,295,500	636,489,020
October 2013	3,583,231	9,169,675	71,664,620	916,967,500	988,632,120
November 2013	4,826,215	13,775,043	96,524,300	1,377,504,300	1,474,028,600
December 2013	6,357,701	20,343,202	127,154,020	2,034,320,200	2,161,474,220
January 2014	8,284,248	31,105,685	165,684,960	3,110,568,500	3,276,253,460
February 2014	10,409,821	45,926,764	208,196,420	4,592,676,400	4,800,872,820
March 2014	10,611,602	50,826,455	212,232,040	5,082,645,500	5,294,877,540
April 13, 2014	10,021,920	48,251,878	200,438,400	4,825,187,800	5,025,626,200
April 2014	9,432,888	45,682,130	188,657,760	4,568,213,000	4,756,870,760

Notes

1. Trailing liability calculated as of the last day of each month based on the weekly Advertising Bonus as described in TelexFree Participant contracts
2. Includes purchases of AdCentral and AdCentral Family plans and excludes commission other than weekly Advertising Bonus
3. Assumes Participants purchasing AdCentral or AdCentral Family plans would place required advertisements and receive Advertising Bonus each week.

Source: Debtors' Participant database.