

**UNITED STATES BANKRUPTCY COURT  
DISTRICT OF MASSACHUSETTS**

**In Re:**

**TELEXFREE, LLC ,  
TELEXFREE, INC.,  
TELEXFREE FINANCIAL, INC.,**

**Debtors.**

**Chapter 11**

**Case No. 14-40987-MSH**

**Case No. 14-40988-MSH**

**Case No. 14-40989-MSH**

**Jointly Administered**

**REPLY BY CHAPTER 11 TRUSTEE TO DOMESTIC AND INTERNATIONAL CLASS  
REPRESENTATIVES' OBJECTION TO MOTION BY CHAPTER 11 TRUSTEE TO  
ESTABLISH OMNIBUS PROCEDURES FOR THE RESOLUTION OF  
DISPUTED PARTICIPANT CLAIMS**

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 (the "Estates") of TelexFree, LLC, TelexFree, Inc., and TelexFree Financial, Inc. (collectively, the "Debtors" or "TelexFree"), respectfully submits this reply (the "Reply") to the Domestic and International Class Representatives' Objection (the "Objection") to the Motion by Chapter 11 Trustee to Establish Omnibus Procedures for the Resolution of Disputed Participant Claims (the "Claims Procedure Motion").

**Introduction**

Through the Claims Procedure Motion, the Trustee seeks approval of omnibus procedures for the resolution of disputed Participant claims. The only objection filed to the Claims Procedure Motion was by the representatives ("Class Net Winner Representatives") in two pending class action adversary proceedings ("Class Action Litigation") of those persons who received more money from the Debtors and third parties in connection with the purchase of membership or phone plans, than such persons paid to the Debtors or third parties in connection



with the purchase of membership or phone plans, determined based upon an aggregation of the Participant's User Accounts (the "Net Winners"). The Class Net Winner Representatives' request to be involved in the claims resolution process would cause delay and substantially increase the costs of resolving claims and distributing funds to Participants who have allowable claims by: relitigating matters that have already been determined, interjecting the Class Net Winner Representatives into a claims process without sufficient standing, and attempting to tie the claims resolution process to the resolution of factual and legal issues in the Class Action Litigation. This should not be permitted. The Court's order approving the net equity formula on January 26, 2016 (the "Net Equity Order") established for all purposes the calculation of the amount of Participant claims in these cases. The Class Net Winner Representatives should not be permitted to challenge through their Objection the Net Equity Order by intervening in the claims allowance process or by submitting class proofs of claim that are not in accordance with the Net Equity Order. The Class Net Winner Representatives have no standing to be heard with respect to the Procedures and the allowance of Participant claims. The requested relief would only cause expense and delay to the Estates, and the Objection should be overruled.

**I. The establishment of the Net Equity formula and development of the claims filing process.**

1. Following his appointment on June 6, 2014, the Trustee was provided access to the Debtors' books and records that had been seized by federal authorities. The Trustee and his professionals then undertook a painstaking process of recreating a working version of the Debtors' electronic records to understand the nature of the Debtors' business and its transactions with Participants.

2. Upon completion of his review, the Trustee concluded, in consultation with his advisors and governmental authorities, that TelexFree was a Ponzi and pyramid scheme.

Participants were promised astronomical returns for placing meaningless advertisements on the internet, and these returns were funded by membership fees paid by new Participants.

3. On October 7, 2015, the Trustee filed his *Motion by Chapter 11 Trustee for Entry of Order Finding that Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief* (the “Ponzi Motion”). By order dated November 25, 2015, as amended on December 21, 2015, the Court found the Debtors to have engaged in a Ponzi and pyramid scheme and that this finding was the law of the case.

4. As part of the Ponzi Motion, the Trustee requested a finding that, because the Debtors were operating a Ponzi and pyramid scheme, claims for accumulated credits should be disallowed and the claims of individuals who lost money from participating in the Debtor’s Ponzi and pyramid scheme (the “Participants”) should be determined using the “Net Equity” formula.

5. The Ponzi Motion, and the supporting affidavit of the Trustee, made clear that, in each Triangular Transaction, it was presumed that the recruited participant paid the membership fee to the recruiting participant, and the recruiting participant retained the membership fee and applied accumulated credits in satisfaction of the membership invoice. *See, e.g., Motion by Chapter 11 Trustee for Entry of Order Finding that Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief [docket 623] at ¶27; 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, at ¶33.*

6. The Court held an initial hearing on the Ponzi Motion on November 24, 2015, after notice to all Participants. At that time, the Court entered the Ponzi finding but deferred a ruling on the Net Equity determination and directed that the Trustee provide additional

information to Participants as to the relief sought. The Trustee provided supplemental notice to all Participants and the hearing was continued to January 26, 2016.

7. The Net Equity Order was entered on January 26, 2016 and provides that:
- (i) in determining the amount of claims of Participants, any claim or portion of claim based upon accumulated credits in a Participant's User Accounts as of the Petition Date shall be disallowed;
  - (ii) the claims amounts of Participants shall be determined on a Net Equity basis, which shall be defined as follows: the amount invested by the Participant into the Debtors' scheme, including amounts paid pursuant to Triangular Transactions, less amounts received by the Participant from the Debtors' scheme, including amounts received pursuant to Triangular Transactions;
  - (iii) In determining the amount of a claim of a Participant who has more than one User Account, the activity in all of the Participant's User Accounts shall be aggregated and netted against one another;
  - (iv) the calculation of a Participant's claim using the Net Equity basis is without prejudice to the Trustee's right to object to the claim of a Participant who had knowledge that the Debtors were engaging in a fraudulent scheme and is therefore not entitled to the claims afforded innocent Participants;
  - (v) the foregoing findings and conclusions shall be applicable for all purposes in these proceedings.

Docket entry 687, at ¶5.

8. On October 7, 2015, the Trustee filed his *Motion by Chapter 11 Trustee for Entry of Order Fixing Bar Date for Filing Proofs of Claim, Approving Form and Manner of Providing Notice, Directing that Claims Be Filed Electronically, and Approving Content of Electronic Proofs of Claim* (the "Claims Motion"). In conjunction with the hearing on the Claims Motion, the Trustee filed, on January 5, 2016, an application to retain BMC Group, Inc. as Agent to Develop the Electronic Proof of Claim Process (the "BMC Application").

9. Pursuant to the Claims Motion, the Trustee requested authority to establish an electronic process for the filing of claims by Participants through the website portal ("Claims

Portal”) to be designed by the Trustee. The Claims Portal asked Participants to input personal data corresponding with the data fields that Participants populated in the Debtors’ records when opening User Accounts, including name, physical address, electronic mail address, home and cell phone numbers, and passwords. Participants were then provided with access to User Accounts that corresponded to the personal data provided by the Participants.

10. Participants were afforded an opportunity to accept or reject the User Accounts that were presented based upon the personal data provided and could add additional User Accounts. Once the User Accounts were confirmed, Participants were provided an opportunity to examine the transaction activity reflected in each of the User Accounts. Participants could then accept or reject individual transactions, modify transaction amounts, or input additional transactions. Participants were afforded an opportunity to submit documentation in support of any modifications. With respect to Triangular Transactions, Participants were asked to confirm that they paid the membership invoice to a recruiting Participant in order to assert a claim for such transactions. Participants were further required to attest under oath to the completeness and accuracy of the claim.

11. On January 26, 2016, the Court held a hearing on the Claims Motion. At that time, the Trustee reviewed with the Court the mechanics of the proposed Claims Portal and electronic proof of claim, including information that would be requested from Participants, User Account information that would be made available to Participants for review, and opportunities that Participants would have to agree to or dispute data provided by the Claims Portal and to add additional data.

12. On January 26, 2016, the Court entered an order approving the Claims Motion (the “Claims Order”), and the BMC Application was approved on January 27, 2016. The Claims

Order provided for a bar date of not less than ninety (90) days after the Claims Portal became operational and notice of the bar date had been served. The Claims Order approved the form and manner of notice of the bar date, including electronic mail notice to all known Participants in English, Spanish and Portuguese, and constructive notice through certain multi-level marketing websites.

13. On May 27, 2016, after the Claims Portal became operational, the Trustee filed a *Notice of Deadline for Filing Electronic Proofs of Claim and Claims Procedures* (the “Bar Date Notice”). The Bar Date Notice established an initial bar date of September 26, 2016 for the filing of electronic claims. The bar date was later extended to December 31, 2016 and then to March 15, 2017. Each bar date notice was served on all Participants in accordance with the provisions of the Claims Order.

14. As referenced in the Claims Procedure Motion, 132,001 Participant Claims were filed through September 28, 2017, including 131,306 that were timely filed and 695 that were filed after the bar date. The Participant claims are based upon transactions reflected in 1,825,687 User Accounts. More than 100,000 of the timely filed Participant claims were made without adjustment by the Participant to the User Accounts or the transactions reflected in those User Accounts.<sup>1</sup>

15. The Claims Procedure Motion seeks to establish a process for determining the claims of Participants, including claims of Participant who, without supporting documentation or explanation, adjusted the number of their User Accounts, adjusted transactions within those User Accounts, or otherwise asserted a claim not in compliance with the Net Equity Order. To the extent that a Participant’s claim is not accepted by the Trustee as filed, the Claims Procedure

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<sup>1</sup> The Trustee reserves all rights with respect to the allowance of these claims and no Participant claim will be considered finally allowed until the Trustee files a list of such claims with the Court.

Motion provides notice and an opportunity to be heard respecting any objections propounded by the Trustee through the Procedures.

### **ARGUMENT**

16. The Class Net Winner Representatives assert their Objection on behalf of the Net Winners who are defendants in the Class Action Litigation. By definition, Net Winners have no claims against the Estates and therefore have no standing to be heard with respect to the claims of Participants who are not Net Winners.

17. The Net Winners do not have an economic interest in the outcome of the claims litigation and therefore are not parties in interest. 11 U.S.C. §502; *In re Freeman*, 540 B.R. 129, 134 (Bankr. E.D. Pa. 2015).

18. The Net Winners' status as defendants in the Class Action Litigation commenced by the Trustee is insufficient to confer standing on the Class Net Winner Representatives to object to Participant claims. *See In re Manshul Const. Corp.*, 223 B.R. 428 (Bankr. S.D.N.Y. 1998). In fact, the Net Winners are not entitled to participate in any distributions by the Trustee until all net winnings are disgorged.

19. Because the Trustee is the Estates' representative vested with responsibility for resolving disputed claims and is exercising that responsibility through the Claims Procedure Motion, the Net Winners have no standing to do so. Leave for a third party to object to claims is not generally accorded unless the trustee refuses to object, "and the bankruptcy court permits the *creditor* to object in the trustee's stead." *In re Thompson*, 955 F.2d 1136, 1147 (1<sup>st</sup> Cir. 1992); *see also In re Fox*, 64 B.R. 148, 151 (Bankr. N.D. Ohio 1986).

20. The claims objection process is expected to be complicated and time consuming. At a minimum, approximately 20,000 claims will need to be resolved. These claims involve

hundreds of thousands of User Accounts and millions of transactions. If the Net Winners were afforded an opportunity to intervene in this already protracted process, the resolution of claims would devolve into a process that is chaotic, inordinately expensive to the Estates, and inconvenient to the Court. *In re Simon*, 179 B.R. 1, 19 (Bankr. D. Mass. 1995).

21. The class proofs of claim do not confer standing on the Class Net Winner Representatives. Each of the class claims is based upon theories of recovery that directly conflict with the Net Equity Order, as set forth below.

22. The first class claim [number 132229-24115]<sup>2</sup> asserts a right to recovery in an unliquidated amount based upon accumulated credits held by Participants at the time the TelexFree Ponzi scheme was terminated. The Net Equity Order specifically provides, however, that claims based upon accumulated credits shall be disallowed. *See infra*.

23. The second class claim [number 132229-24114] and the third class claim [number 132229-24113] are both premised upon the theory that the Participants were actually employees of TelexFree. The second class claim asserts a claim in an unliquidated amount for damages under the Massachusetts Wage Act. The third class claim asserts a claim in an unliquidated amount for damages as misclassified independent contractors entitled to wages under the Massachusetts Wage Act. Each of these claims is also in direct conflict with the Net Equity Order, which provides a uniform method for calculating allowable claims of Participants in these proceedings, exclusive of other theories of recovery. The Trustee sought and obtained the Net Equity Order earlier in these cases for this very reason – to provide consistency and predictability to the claims resolution process.

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<sup>2</sup> The number assigned to the class proofs of claim is higher than the total number of claims filed by that date because certain claim numbers were not used, for example, claimants who registered with the Claims Portal but did not file a claim.



24. At bottom, the Class Net Winner Representatives are attempting to challenge the methodology by which Participant claims will be determined.<sup>3</sup> The Participants whose claims are subject to objection by the Trustee are the proper parties in interest to be heard.<sup>4</sup>

25. For the foregoing reasons, the Objection should be overruled, and the Court should grant such other relief as is just and proper.

STEPHEN B. DARR,  
CHAPTER 11 TRUSTEE,  
By his attorneys,

/s/ Andrew G. Lizotte

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Dated: November 27, 2017  
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<sup>3</sup> The Class Net Winner Representatives have challenged the assumptions underlying the Triangular Transactions. While the inclusion of the Triangular Transactions in the computation of net winnings in the Class Action Litigation remains unresolved, the inclusion of such Triangular Transactions as a component of Net Equity for purposes of determining allowable Participant claims has already been finally determined pursuant to the Net Equity Order.

<sup>4</sup> While the composition of Net Winners may change based upon a review of transactions associated with a particular Participant, the Class Net Winner Representatives will continue to represent only those individuals who are Net Winners and, therefore, defendants in the Class Action Litigation.

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**CERTIFICATE OF SERVICE**

I, Andrew G. Lizotte, hereby certify that on November 27, 2017, I caused to be served a copy of the following *Reply by Chapter 11 Trustee to Domestic and International Class Representatives' Objection to Motion by Chapter 11 Trustee to Establish Omnibus Procedures for the Resolution of Disputed Participant Claims* via operation of this Court's CM/ECF System, by Electronic Mail, and by First Class Mail, postage prepaid as indicated on the attached service list.

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