

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS**

)	
In re:)	Chapter 11
)	Case No. 14-40987-MSH
TELEXFREE, LLC <i>et al.</i>)	Jointly Administered
)	
Debtors)	
)	
)	
STEPHEN B. DARR, AS TRUSTEE OF)	
THE ESTATES OF TELEXFREE, LLC,)	
TELEXFREE, INC. AND TELEXFREE)	Adversary Proceeding
FINANCIAL, INC.)	No. 15-4055
)	
Plaintiff)	
)	
v.)	
)	
RITA DOS SANTOS, INDIVIDUALLY)	
AND AS PUTATIVE CLASS)	
REPRESENTATIVE AND MARIA)	
MURDOCH, ANGELA BATISTA)	
JIMENEZ, ELISANGELA OLIVEIRA)	
AND DIOGO DE ARAUGO, AS)	
PUTATIVE CLASS)	
REPRESENTATIVES)	
)	
Defendants)	
)	

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW ON CROSS-MOTIONS FOR SUMMARY JUDGMENT

Before me are cross-motions for summary judgment filed by the plaintiff, Stephen B. Darr, the trustee in the jointly administered chapter 11 cases filed by Telexfree, LLC, Telexfree, Inc. and Telexfree Financial, Inc. (individually and collectively, “Telexfree”), and an interested party, the Plaintiffs’ Interim Executive Committee (“PIEC”), appointed by the United States



District Court to represent the victims of the Telexfree fraud.¹ In this adversary proceeding, Mr. Darr seeks to enjoin the defendants, individually and as putative class representatives of Telexfree's victims, from proceeding with claims for unjust enrichment in lawsuits filed in the district court against certain participants in the Telexfree Ponzi and pyramid schemes.²

The dispute before me is over who, as between Mr. Darr and the Ponzi scheme victims, is the proper party to pursue recovery from the class of Telexfree participants who profited from the scheme, the so-called "Net Winners." Mr. Darr requests summary judgment on counts I and III of his amended complaint. In count I he seeks a declaratory judgment that the defendants' unjust enrichment claims are property of the Telexfree bankruptcy estates, and in count III he asks for an injunction enjoining the defendants from prosecuting those claims directly. The PIEC seeks summary judgment dismissing Mr. Darr's complaint on the basis that he lacks standing to

¹ The PIEC was appointed to represent victims of the debtors' Ponzi/pyramid scheme by Judge Timothy Hillman of the United States District Court for the District of Massachusetts on December 23, 2014, in the multidistrict litigation pending in that court, *In re: Telexfree Securities Litigation*, MDL No. 14-02566 (the "MDL Proceeding"). See MDL Case Management Order No. 3 attached as Exhibit A to the PIEC's Statement of Undisputed Facts.

² The first action was commenced by Ms. Dos Santos and others in the district court and consolidated in the MDL Proceeding. A motion to amend the complaint to add a count for unjust enrichment precipitated the filing of this adversary proceeding. After the district court denied the motion to amend, a second action was filed in the district court by Elisangela Oliveira and others (CA No. 16-40018-TSH) (the "Oliveira Lawsuit"). Judge Hillman, finding that the second action was an attempt by the class action plaintiffs to circumvent his ruling denying their motion to amend, stayed the Oliveira Lawsuit. Both Ms. Dos Santos and Ms. Oliveira are defendants in this adversary proceeding. On May 26, 2017, Judge Hillman modified the stay to permit Ms. Dos Santos and Ms. Oliveira to amend their complaints to add additional parties and to assert additional counts in order to pre-empt the running of relevant statutes of limitation. See 14-02566-TSH, documents #495 and #503 and 16-40018-TSH, document #12, attachment 1.

prosecute claims against the Net Winners because neither the money he seeks to recover nor the claims by which a recovery may be effected qualifies as property of the Telexfree entities or their bankruptcy estates. An *amicus curiae* brief supporting Mr. Darr's cross-motion for summary judgment has been filed by a group of Net Winners who comprise a certified class of defendants in a separate adversary proceeding brought in the Telexfree chapter 11 cases.³

Procedural Posture

On January 15, 2016, the United States District Court for the District of Massachusetts withdrew the reference in this adversary proceeding but returned the proceeding to this court "to rule on any preliminary or pretrial matters, hear any dispositive motions, conduct a trial if necessary, and submit [to the district court] proposed findings of fact and conclusions of law with respect to any dispositive motions or trial."⁴ After the parties' unsuccessful attempts at mediation, and upon review and consideration of all the parties' submissions and their very able oral presentations, I now submit to the District Court the following proposed findings of fact and conclusions of law pursuant to its order withdrawing the reference.

Facts

The material facts necessary to support a ruling on the cross motions are not in dispute. They are taken from the admitted portions of the statements of uncontested facts filed by the

³ See *amicus* brief, document #89. See also *Darr v. Argueta et al.* Adv. Proc. No 16-4006. The class is represented by the law firm of Milligan Rona Duran & King LLC.

⁴ See 16-40004-TSH, document #2.

parties in support of their respective motions for summary judgment and from the uncontested statements in the Affidavit of Stephen B. Darr in Opposition to the PIEC Motion for Summary Judgment and in Support of the Trustee's Cross-Motion for Summary Judgment (the "Darr Summary Judgment Affidavit").⁵ I also take judicial notice of the dockets in the Telexfree chapter 11 cases, in this and other adversary proceedings filed in the Telexfree chapter 11 cases, and in the Telexfree cases pending in the District Court.

Telexfree's Scheme

Telexfree, LLC, the lead debtor in these cases, is a Nevada limited liability company with its headquarters in Marlboro, Massachusetts.⁶ Telexfree purported to sell cheap long distance telephone service to over 40 countries using Voice over Internet Protocol or "VoIP".⁷ It targeted immigrant communities in the U.S. as well as their countrymen and many others around the

⁵ Document #49.

⁶ U.S. Securities and Exchange Commission's Motion for Change of Venue, Memorandum of Points and Authorities and Declarations of Mark Albers and Scott Stanley (14-40987, document #67). Telexfree, Inc. is a Massachusetts corporation while Telexfree Financial, Inc. is a Florida corporation that is owned by Telexfree, LLC.

⁷ Trustee's Statement of Undisputed Facts, document #48, at ¶ 1. PIEC's Statement of Uncontested Facts, document #40, ¶ 11. *See also* the Affidavit of Stephen B. Darr filed in support of his motion for class certification in *Darr v. Alecci*, Adversary Proceeding No. 16-4007, document #2 ("Darr's Alecci Affidavit") and ¶¶ 21-35 of the Affidavit of Stephen B. Darr in Support of Chapter 11 Trustee's Motion for Entry of Order that Debtors Engaged in Ponzi and Pyramid Scheme and Related Relief, (the "Ponzi Scheme Affidavit"), which is document #623 of Telexfree's main bankruptcy case (14-40987) and attached as part of Exhibit O in the PEIC's Statement of Uncontested Facts, document #40. The Ponzi Scheme Affidavit is also incorporated by reference in the Darr Summary Judgment Affidavit.

world.⁸ Telexfree's real business and the source of almost all its revenue, however, was the recruitment from these communities of members (also referred to as participants and promoters) to sell memberships and VoIP plan packages to others.⁹ Participants received financial incentives to recruit additional members thereby creating an ever-expanding pyramid with money flowing upstream in a gravity-defying process enriching the upper-level members.¹⁰ Telexfree's "products," the long distance calling plans themselves, were a mere pretext to create the appearance that Telexfree had a business.¹¹ It was the right to sell the products and memberships that generated widespread interest among the communities targeted by Telexfree, both domestic and foreign, who believed that participation in the Telexfree program was a fast track to easy street.¹²

Membership in Telexfree's program was ostensibly governed by a contract—an untitled, 16-page, single-spaced, small-print document.¹³ The contract gives the impression, especially to a layperson, of great formality, solemnity and weight, but in fact much of it is incomprehensible.

⁸ Trustee's Statement of Undisputed Facts, at ¶ 1.

⁹ *Id.* at ¶¶ 1-3.

¹⁰ *Id.*

¹¹ *Id.* See also *id.* at ¶¶ 8 and 9.

¹² *Id.* at ¶¶ 2-4.

¹³ Exhibit C to Trustee's Statement of Undisputed Facts. It is unclear whether and how participants executed the contract, if at all.

For example, section 2.2 entitled “Purpose of the Contract” is followed by subsection 2.2.1 entitled “Synthesis of the legal relationship” [sic] which provides:

The user, by accessing the website of TELEXFREE.com [,] can become a member through payment of the respective fee, which will provide access to the TelexFREE Multilevel Marketing network for the period of one year, without extension or renewal. At this stage, the member is called a PARTNER. The PARTNER will have the right to acquire, at an exclusive discount, products that are offered on the website www.telexfree.com, with the principal VOIP telephony accounts called 99TELEXFREE. The PARTNER, upon acquiring them in the form of a kit (ADCENTRAL or FAMILY kit) assumes the title of PROMOTER and, as such, receives a space on the site www.telexfree.com to promote the products/services that he has acquired. He also receives training and access to materials also made available on the TELEXFREE website so that he can undertake to promote the latter and avail himself of the opportunity to be a PARTNER and PROMOTER to others in his circle of relationships. All activities are performed by the PARTNER/PROMOTER without any employment relationship, and they are able individually to manage the team and the resources it seeks to make available for such purpose, of their own free will. For the promotion of products/services he will receive a bonus in direct proportion to his results, based on the levels explained in a separate section in these GENERAL REGULATIONS. He must obey all the clauses of the GENERAL REGULATIONS so that the name of TELEXFREE and juridical persons associated with it remain unblemished. [sic]

When a new member participant signed on to the Telexfree program, Telexfree opened a user account for the member participant.¹⁴ Each user account was registered to a specific email address, thus allowing Telexfree to track participant activity.¹⁵ Participants could have more than

¹⁴ PIEC’s Statement of Uncontested Facts at ¶ 12.

¹⁵ Exhibit O to PIEC’s Statement of Uncontested Facts at ¶ 39.

one user account and, indeed, many of them did.¹⁶ Based on the trustee's reconstruction of Telexfree's database, there are 10,987,617 identified user accounts.¹⁷

Participants would receive credits to their user accounts from Telexfree for selling memberships or VoIP packages or for posting internet advertisements hawking Telexfree's products.¹⁸ These internet advertisements were prepared by Telexfree and made available to members to post *anywhere* on the internet without regard to whether the ads led to a single sale.¹⁹ Indeed, Telexfree's sales pitch promised participants astronomical returns merely for posting these meaningless advertisements.²⁰ Those returns, mostly in the form of credits, like the credit for selling VoIP plans or memberships, were generally deposited into the participant's user account.²¹

When a participant recruited a new member, Telexfree would issue an invoice to the recruited participant for the fees due for the VoIP plan or membership purchase.²² The recruited

¹⁶ Ponzi Scheme Affidavit at ¶ 39.

¹⁷ *Id.* at ¶ 30 and ¶¶ 37-49.

¹⁸ PIEC's Statement of Uncontested Facts at ¶ 13, citing the amended complaint at ¶ 11.

¹⁹ Darr's Alecci Affidavit at ¶ 14. Trustee's Statement of Undisputed Facts at ¶ 2 and the PIEC's response thereto (document #77).

²⁰ Trustee's Statement of Undisputed Facts at ¶ 2.

²¹ Darr Summary Judgment Affidavit at ¶¶ 5 and 9-10.

²² See PIEC's Statement of Undisputed Facts at ¶ 15 and 16.

participant could pay the invoiced amount either directly to Telexfree or to the member who recruited him or her.²³ The recruiting participant could, and frequently did, retain the fees paid by the recruited participant.²⁴ When this occurred, Telexfree considered its obligation to pay the recruiting participant for outstanding credits in the same amount satisfied, treated the redemption of credits as income to the recruiting participant, issued an Internal Revenue Service (“IRS”) Form 1099 to the recruiting participant for credits redeemed and considered the recruited participant’s invoice paid in full.²⁵

The vast majority of fees paid by recruited participants were retained by the recruiting participants in redemption of their Telexfree credits. The face value of all the invoices associated with the sale of Telexfree membership plans or VoIP packages was \$3,073,461,326, but only \$359,792,242 (approximately 11.7%) of that amount was paid in cash directly to Telexfree.²⁶ Telexfree recorded the cash and credit redemption transactions as separate accounting items. When an invoice was satisfied by a cash payment, the revenue was categorized as “payments through bank” while the redemption of credits owed to a recruiting participant who held on to the recruited participant’s payment was reflected as “payment through system.”²⁷ Telexfree’s 2013

²³ *Id.*

²⁴ *Id.*

²⁵ Darr Summary Judgment Affidavit at ¶¶ 10, 19 and 20.

²⁶ See PIEC’s Statement of Undisputed Facts at ¶ 19.

²⁷ Darr Summary Judgment Affidavit at ¶ 15.

profit and loss statement referred to funds retained by a recruiting participant as “Agent Commissions.”²⁸ Telexfree booked “payments through the system” as income to the company and “agent commissions” as company expenses.²⁹

Telexfree’s scheme was predicated upon recruited participants becoming recruiting participants in their own right, thereby creating the pyramid. By the time the scheme collapsed as all such schemes inevitably do, the trustee estimates that Telexfree had a million participants,³⁰ making it perhaps the largest Ponzi scheme in history in terms of number of victims.

The Bankruptcies

On April 13, 2014, each of the debtors filed a voluntary petition for relief under chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Nevada. By orders dated May 6, 2014, the bankruptcy cases and associated adversary proceedings were transferred to this court. On June 6, 2014, Mr. Darr was appointed the chapter 11 trustee in each case upon the motion of the United States trustee.

Subsequent to his appointment, Mr. Darr filed a motion requesting court rulings, for all purposes in the chapter 11 cases, that Telexfree had engaged in a Ponzi and pyramid scheme, that

²⁸ Trustee’s Statement of Undisputed Facts at ¶ 11.

²⁹ *Id.* at ¶ 10.

³⁰ Mr. Darr has estimated that there are approximately 900,000 unique email addresses that are linked to approximately 11,000,000 user accounts. Ponzi Scheme Affidavit at ¶ 39.

the so-called “Ponzi scheme presumption” would apply,³¹ and that accumulated but unredeemed credits owed to a participant would not be included in the calculation of any participant’s proof of claim filed in the bankruptcy cases (the “Ponzi Motion”). Mr. Darr requested that a participant’s claim be calculated as the total amount of money paid by a participant to either Telexfree or another participant less all amounts received by the participant from Telexfree or another participant. This formula, the so-called “net equity formula,” has been adopted by other courts in calculating the claims of victims of Ponzi and pyramid schemes.³² Using the net equity formula, the total amount a participant paid, whether to Telexfree or to a recruiting participant, minus the amount of money that the participant received, whether from Telexfree or a recruited participant, results in the amount of the participant’s claim. Mr. Darr proposed that all user accounts of a participant be aggregated for this calculation. By applying the net equity formula, participants would fall into two categories—“Net Winners” and “Net Losers.” As these terms suggest, Net Winners are those who received more from Telexfree and other participants than they paid to Telexfree and other participants, while the opposite is true for Net Losers. Mr. Darr maintained that only Net Losers should be entitled to participate as creditors in the bankruptcy cases.

³¹ The Ponzi scheme presumption presumes that all transfers made in furtherance of a Ponzi scheme are made with fraudulent intent. *DeGiacomo v. Sacred Heart Univ. (In re Palladino)*, 556 B.R. 10, 14 (Bankr. D. Mass. 2016).

³² See, e.g., *Marshall v. Picard (Bernard L. Madoff Inv. Securities LLC)*, 740 F.3d 81, 85 (2d Cir. 2014) (“*Madoff II*”); *Donell v. Kowell*, 533 F.3d 762, 772 (9th Cir. 2008).

The PIEC opposed the Ponzi Motion out of a concern that its allowance would bind all parties to Mr. Darr's methodology for determining Net Winners and Losers in the bankruptcy cases, which would result in his competing with them in attempting to recover payments directly between participants.

After an evidentiary hearing on the Ponzi Motion on November 24, 2015, I determined that Telexfree had indeed operated a Ponzi and pyramid scheme, that the Ponzi scheme presumption would apply, and that each of the debtors would be jointly and severally liable for the claims of the victims of the scheme.³³ I reserved on the issues of whether the net equity formula was the appropriate method for calculating claims in the cases and whether the trustee or the PIEC was the appropriate party to bring claims against Net Winners who retained funds paid by recruited participants. After a further hearing on January 26, 2016, I entered an order adopting the net equity formula as the method to be used in calculating a participant's claim.³⁴

Mr. Darr commenced this adversary proceeding on October 7, 2015, with a two-count complaint seeking a declaratory judgment that the defendants' unjust enrichment claims asserted in the District Court violated the automatic stay in effect as a result of the Telexfree bankruptcies

³³ Order dated November 25, 2015, docketed in Telexfree's main bankruptcy case (14-40987) as document #654, subsequently amended by order dated December 21, 2015. See document #668. A transcript of the evidentiary hearing is attached to the PIEC's Statement of Undisputed Facts as Exhibit N and also on the docket in Telexfree's main bankruptcy case as document #658.

³⁴ Order of January 26, 2016, docketed in 14-40987 as document #687.

and seeking an injunction enjoining the defendants from prosecuting those claims. In an amended complaint, Mr. Darr added a third count for damages resulting from the stay violation.

The Dispute

Mr. Darr as trustee wishes to recover from Net Winners for the benefit of the bankruptcy estates payments they received from or on behalf of Telexfree in excess of what they paid in. He has in fact begun to do so by commencing two class action adversary proceedings against thousands of alleged Net Winners, both domestic (Adv. Pro. No. 16-4006) and foreign (Adv. Pro. No. 16-4007).³⁵ Mr. Darr's recovery effort includes preference and/or fraudulent transfer claims against Net Winners to recover monies paid to them directly by recruited participants. He views the defendants' efforts to assert unjust enrichment claims against these Net Winners as interfering with his efforts.

Mr. Darr maintains that a recruiting participant's right to retain the fees received from a recruited participant arose because the recruiting participant had accumulated credits in his or her Telexfree user account. As a result, by retaining the fees, a recruiting participant effectively redeemed a portion of her credits while Telexfree applied the redemption amount to pay the invoice issued to the recruited participant. This Mr. Darr characterizes as a "triangular transaction."³⁶

³⁵ The *amicus* here is the class of domestic Net Winner defendants in Adv. Pro. No. 16-4006.

³⁶ Mr. Darr analogizes this to a bankruptcy trustee's garden-variety recovery action for an indirect fraudulent or preferential transfer where debtor owes or wants A to receive \$100 and B owes \$100 to debtor. Debtor instructs B to pay the \$100 directly to A and considers B's indebtedness to debtor paid in full. Even though debtor never touched the \$100, a bankruptcy

The trustee views all monies paid by a recruited participant to a recruiting participant as property in which Telexfree had an interest and so any attempt by Net Losers to sue Net Winners directly on a theory of unjust enrichment would amount to interference with property of the bankruptcy estates, namely the estates' interest in recovering that property through avoidance actions. This would violate the automatic stay. Mr. Darr maintains that excluding payments by a recruited participant to a recruiting participant from the reach of his trustee avoidance powers would sabotage the net equity formula. He points out that the court has already approved the use of the net equity formula in calculating claim amounts and suggests that this reflects the court's recognition that triangular transaction payments involved Telexfree property.

Mr. Darr asserts that in the aftermath of a Ponzi scheme the overriding concern of the court must be for ratable distribution of funds to all victims. He stresses that victims' claims in the Telexfree fraud were not particularized or susceptible to remedies such as the imposition of a constructive trust. He notes that due to an overriding concern that all Ponzi scheme victims receive equal treatment, a number of courts of appeal, including most recently the Eleventh

trustee may sue A for recovery if the transfer otherwise qualifies for avoidance. *Warsco v. Preferred Technical Group*, 258 F.3d 557, 564 (7th Cir. 2001). "As the explicit language of the Bankruptcy Code makes clear. . . the transfer need not be made directly by the debtor; indirect transfers made by third parties to a creditor on behalf of the debtor may also be avoidable under the Code. *Id.* (quoting *Dean v. Davis*, 242 U.S. 438, 443, 37 S. Ct. 130, 61 L. Ed. 419 (1917) ("Mere circuitry of arrangement will not save a transfer which effects a preference action from being invalid as such"))).

Circuit in *United States v. Ramunno*, 599 F.3d 1269 (11th Cir. 2010), have refused to impose constructive trusts in favor of defrauded victims even when those victims could trace their investments.³⁷

The PIEC couldn't disagree more with Mr. Darr's view of the case. It characterizes the payments by recruited participants to recruiting participants not as triangular transactions but as "participant-to-participant payments." The PIEC argues that Telexfree had no interest whatsoever in those payments so their disposition did not in any way diminish the Telexfree bankruptcy estates, a critical predicate to a trustee's prevailing on avoidance action claims. It views the trustee's triangular transaction construct as absurd because Telexfree was essentially a criminal enterprise and thus all the so-called debits and credits in and out of user accounts and the participant invoices were phony. These phantom transactions, the PIEC declares, had no impact on Telexfree's property as Telexfree never had possession of any of the cash. According to the PIEC all of the reported decisions in which a trustee had standing to bring avoidance-type claims in a Ponzi case involved the debtors' having had physical possession of the property obtained by fraud. Since Telexfree never had physical possession of the participant-to-participant funds, notes the PIEC, Mr. Darr's pursuit of recruiting participants who were Net Winners using his strong arm powers under the Bankruptcy Code will be a waste of time and money.

³⁷ The *amicus* agrees with Mr. Darr's characterization of the claims against recruiting participants as fraudulent transfers. It urges that the causes of action which the PIEC asserts belong to the victims are identical to and derivative of the trustee's fraudulent transfer claims and thus should be enjoined.

The PIEC asserts that it was not Telexfree which suffered losses as a result of the participant-to-participant payments; it was each recruited participant who turned out to be a Net Loser. Thus the losses were particularized to the Net Losers. The PIEC cites, among other decisions, *Caplin v. Marine Midland Grace Tr. Co. of N.Y.*, 406 U.S. 416 (1972), and the third of the Second Circuit’s Madoff trilogy, *Picard v. Fairfield Greenwich Ltd.*, 762 F.3d 199, 211 (2d Cir. 2014) (“*Madoff III*”), for the proposition that Ponzi scheme investors who suffer particularized harm caused by third parties may pursue direct causes of action against those parties while a bankruptcy trustee lacks standing to do so.

The Summary Judgment Standard

A court “shall grant summary judgment if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law.” Fed. R. Civ. P. 56, made applicable by Fed. R. Bankr. P. 7056.

A genuine issue is “one supported by such evidence that ‘a reasonable jury, drawing favorable inferences,’ could resolve [the issue] in favor of the nonmoving party.” *In re McCarthy*, 473 B.R. 485, 491 (Bankr. D. Mass. 2012) (quoting *Triangle Trading Co. v. Robroy Indus., Inc.*, 200 F.3d 1, 2 (1st Cir. 1999)). A material fact is one that might affect the outcome of the case under the governing law. *See id.* at 491.

The moving party in a summary judgment motion bears the initial burden of demonstrating that no genuine issue of material fact exists by pointing to materials of evidentiary quality such as affidavits or depositions that are so one-sided as to warrant judgment as a matter of law. *See Anderson v. Liberty Lobby*, 477 U.S. 242, 252 (1986); *In*

re Varrasso, 37 F.3d 760, 763 (1st Cir. 1994). “Only if the record, viewed in that manner and without regard to credibility determinations, reveals no genuine issue as to any material fact may the court enter summary judgment.” *Cadle Co. v. Hayes*, 116 F.3d 957, 959 (1st Cir. 1997).

Discussion

Whether Mr. Darr has standing to pursue recovery of funds paid by Net Losers directly to Net Winners as fraudulent or preferential transfers begins with determining whether Telexfree had an interest in those funds at the time of their transfer. *See Rine & Rine Auctioneers, Inc. v. Douglas County Bank & Trust Co. (In re Rine & Rine Auctioneers, Inc.)*, 74 F.3d 854, 857 (8th Cir. 1996).³⁸ Putting aside for the moment the

³⁸ Bankruptcy Code section 547 provides in relevant part:

- (b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any *transfer of an interest of the debtor in property*—
 - (1) to or for the benefit of a creditor;
 - (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
 - (3) made while the debtor was insolvent;
 - (4) made—
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
 - (5) that enables such creditor to receive more than such creditor would receive if—
 - (A) the case were a case under chapter 7 of this title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.
- (Emphasis added).

unique issue of fraud, if Telexfree had an interest in the funds retained by a recruiting participant, then Mr. Darr and only Mr. Darr would have standing to seek to recover those funds using his statutory avoidance powers. *Morley v. Ontos, Inc.* (*In re Ontes, Inc.*), 478 F.3d 427, 431 (1st Cir. 2007) (fraudulent transfer); *In re Bodenstein*, 248 B.R. 808, 817 and n. 39 (Bankr. W.D. Ark.) (collecting cases), *aff'd*, 253 B.R. 46 (B.A.P. 8th Cir. 2000) (preferential transfer).

While the term “interest in property” is not defined in the Bankruptcy Code, it is often equated with the term “property of the estate,” which is. *See Bergquist v. Anderson-Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.)*, 850 F.2d 1275, 1279 and n. 8 (8th Cir. 1988). *See also Rine & Rine Auctioneers*, 74 F.3d at 857 (“The phrase ‘property of the debtor’ in the pre-1984 version of § 547(b), which was replaced by ‘an interest of the debtor in property,’ is equivalent to ‘property of the estate’ for purposes of determining whether the transfer of proceeds derived from the debtor’s sale of transferee’s assets constituted a voidable preference”).

Bankruptcy Code § 548(a)(1) provides in relevant part:

The trustee may avoid any *transfer . . . of an interest of the debtor in property . . .* that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

- (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted. (Emphasis added).

Bankruptcy Code § 541(a) is clear that property of the estate includes, with exceptions not relevant here, all legal or equitable interests of the debtor in property as of the commencement of the case “wherever located and by whomever held.” 11 U.S.C. § 541(a). “The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property . . .” S. Rep. No. 95–989, 95th Cong., 1st Sess. 82 (1978), reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5868. *See also United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204–05, 103 S. Ct. 2309, 76 L.Ed.2d 515 (1983). Its intended breadth enables the bankruptcy court to control a debtor’s property, wherever found, for equitable distribution to creditors. *Straton v. New*, 283 U.S. 318, 320–21 (1931).

In determining what is property of the estate, courts look to state law. *Butner v. United States*, 440 U.S. 48, 55 (1979). Neither party has opined as to which state’s law controls in this proceeding. To determine what state’s law applies, a federal court utilizes the choice of law provision of the forum state. *Crellin Technologies, Inc. v. Equipmentlease Corp.*, 18 F.3d 1, 4 (1st Cir. 1994). Massachusetts courts “give effect to the law reasonably chosen by the parties to govern their rights under contracts so long as there is no substantial conflict with Massachusetts public policy and the designated state has some substantial relation to the contract.” *N. Parent, Inc. v. Cotter & Co. (In re N. Parent, Inc.)*, 221 B.R. 609, 620 n. 11 (Bankr. D. Mass. 1998). Here, the Telexfree membership contract designates Nevada law as governing “issues arising from this instrument.” Under Nevada law, fraud in the inducement renders a contract voidable but

not void. *Bishop v. Stewart*, 13 Nev. 25, 42 (Nev. 1878). This principle is neither remarkable nor unique and is the law in many states including Massachusetts. *See Shaw's Supermarkets, Inc. v. Delgiacco*, 410 Mass. 840, 842 (Mass. 1991).

The parties agree that no participant ever took steps to repudiate his or her membership contract with Telexfree. Under the contract Telexfree had the right to collect member fees but allowed a recruiting participant to hold on to those fees in exchange for redemption of credits in his Telexfree user account. That Telexfree treated membership fees as its own is reflected in its financial records and practices. Telexfree recorded participant-to-participant payments as "payments through the system" and booked these payments as a company expense for agents' commissions. It issued IRS Forms 1099 to recruiting participants who held on to the membership fees.

That the funds retained by a recruiting participant never physically passed through Telexfree's bank accounts does not matter for purposes of determining whether Telexfree had an interest in the funds. Physical possession is not the foundation upon which a determination of property of the estate rests. Bankruptcy Code § 541 includes property "wherever located and by whomever held." An entity may have constructive possession of property. Even in the arguably more stringent criminal context, courts hold that "[p]ossession implies 'control and power,' exclusive or joint ..., or, in the case of 'constructive possession,' knowledge coupled with the ability and intention to exercise dominion and control." *Com. v. Arias*, 29 Mass. App. Ct. 613, 617, 563 N.E.2d 1379,

1382 (Mass. App. Ct. 1990), *aff'd*, 410 Mass. 1005, 572 N.E.2d 553 (Mass. 1991).

Bankruptcy Code § 101(54) is also instructive. It provides:

“The term ‘transfer’ means— . . .

(D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—

- (i) property; or
- (ii) an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption.”

“This definition is broad and covers not only the everyday buying and selling of goods, but also the transfer of a partial interest or a transfer that is not accompanied by a change of possession.”

Lehtonen v. Time Warner, Inc. (In re PurchasePro.com, Inc.), 332 B.R. 417, 426–27 (Bankr. D. Nev. 2005).

The PIEC does not necessarily disagree with any of this so long as the analysis is applied narrowly to the mill-run debtor actually engaged in business. The PEIC notes, however, that Telexfree was a criminal enterprise, its entire business model was a scam and all the funds involved in the scam were fraudulently obtained. The PIEC argues that when it comes to Ponzi scheme cases, the debtor must have had actual physical possession of the fraudulently generated funds for a bankruptcy trustee to have standing to deploy his or her avoidance powers to recover them. Since payments made directly between participants never came into Telexfree’s possession the PIEC maintains that Mr. Darr has no standing to sue to recover them and further that those funds should be impressed with a constructive trust for the benefit of the defendants. The PIEC also argues that the harm to the recruited participants who were Net Losers was particularized to them and that Mr. Darr lacks standing to compete with them for the same recovery.

While it is indeed the case that all reported decisions in which courts have recognized a bankruptcy trustee's standing to bring avoidance actions to recover funds transferred by a Ponzi scheme debtor involved funds actually in the debtor's possession, there is nothing in the Bankruptcy Code requiring that such possession be physical as opposed to constructive or indirect. The underlying principle upon which a bankruptcy trustee's avoidance power is based is that even as to property fraudulently obtained by a debtor, while unassailable title to such property may not have passed to the debtor, the debtor nevertheless obtains a defeasible interest in the property. *Bailey v. Big Sky Motors, Ltd. (In re Ogden)*, 314 F.3d 1190, 1198 (10th Cir. 2002) (defeasible title held by debtor who obtained funds by fraud). This principle would seem to apply with equal force whether the property is obtained directly or merely remotely or derivatively. By its nature, every triangular transaction underlying a participant-to-participant payment began with the creation of a debt owed by the recruited participant to Telexfree which Telexfree allowed to be repaid by the recruited participant's forwarding money directly to a recruiting participant to whom Telexfree had an obligation. The mere fact that the money flowed directly from a recruited participant to a recruiting participant rather from the recruited participant to Telexfree and then to the recruiting participant should not be the determining factor in Mr. Darr's standing to bring avoidance actions to recover that money for the benefit of all Telexfree's creditors.

The PIEC's claim that the funds paid by recruited participants to recruiting participants are being held in constructive trust for the benefit of the defendants reflects a

common misunderstanding of the nature of such trusts. “Nearly all literature on constructive trusts makes the point that a constructive trust is a remedy, rather than a substantive property right. It is not a trust, but an analogy to a trust employed to correct unjust enrichment.” Emily L. Sherwin, *Constructive Trusts in Bankruptcy*, 1989 U. Ill. L.R. 297, 310 (1989). “A constructive trust is a legal fiction, a common-law remedy in equity that may only exist by the grace of judicial action.” *XL/Datacomp, Inc. v. Wilson*, 16 F. 3d 1443, 1449 (6th Cir. 1994). The fact that a defrauded party has available the remedy of a judicially imposed constructive trust as to certain property does not deprive the party against whom the constructive trust remedy may be imposed from having rights in that property until such time as the trust is imposed. And further, unless the defrauded party can identify the property specifically, the ability to obtain the judicial remedy of constructive trust will be lost once a bankruptcy petition is filed. These principles were laid out nearly a century ago by the United States Supreme Court in the eponymous Ponzi case, *Cunningham v. Brown*, 44 S. Ct. 424 (1924). The defendants in this adversary proceeding cannot trace the funds they paid to the recruiting participants, and so their ability to seek the imposition of a constructive trust at this point has been lost.

“Constructive trusts are anathema to the equities of bankruptcy since they take from the estate, and thus directly from competing creditors, not from the offending debtor.”

XL/Datacomp, Inc., 16 F.3d at 1452.

The very reasoning that mandates denying the constructive trust remedy to the Telexfree victims also explains why their claims are not particularized. While each of the

victims no doubt views his or her loss as unique, from the vantage of the Telexfree bankruptcy estates, the victims are indistinguishable. Allowing one victim to elevate her claim over the claims of others thwarts the policy of ratable distribution at the heart of our bankruptcy system. *Id.* at 1451.

As Mr. Darr emphasizes, many of the defendants who claim no involvement with Telexfree actually had extensive interaction with the company as reflected by their multiple user accounts. For example, defendant Maria Murdoch testified at a November 24, 2015 evidentiary hearing that while she had invested approximately \$25,000 in Telexfree, she never had contact with Telexfree, never became a member of Telexfree, and never received an invoice from Telexfree.³⁹ Telexfree's books and records, however, reflect that Ms. Murdoch maintained seventy-five user accounts.⁴⁰ In fact, all of the named parties in various actions had multiple user accounts with Telexfree. They include: Rita Dos Santos, who had twelve accounts; Angela Batista Jiminez, who had fifty-five; Elisangela Oliveira, who had three; Diogo De Araugo, who had sixty-five; and Celio Da

³⁹ Trustee's Statement of Uncontested Facts at ¶ 41.

⁴⁰ *Id.* at ¶ 42.

Silva, who had one-hundred forty-two.⁴¹ In addition Ms. Dos Santos received \$8,035.91 in payments directly from Telexfree.⁴²

The cases relied upon by the PIEC, such as *Caplin* and *Madoff III*, do not support a finding of particularized harm in this proceeding. This is not a case where the trustee is asserting claims that do not belong to the Telexfree estate as in *Caplin*, where the trustee sought to sue an indenture trustee based on claims belonging not to the debtor but to the debenture holders under the indenture. Nor is it the case that the defendants here seek to assert claims against the recruiting participants that are distinct from the claims of Mr. Darr as in *Madoff III*, where investors who were customers of so-called “feeder funds,” and not Madoff’s funds, sought to sue the feeder funds directly. On the contrary, the relationships here more closely resemble those in the second of the Second Circuit’s Madoff trilogy, *Madoff II*, where Madoff customer/victims sought to sue Jeffrey Picower and his affiliates, who were Madoff’s co-conspirators, for conversion and other non-bankruptcy causes of action. The Second Circuit upheld an injunction issued by the bankruptcy court barring suit. The court ruled that the victims’ suit was nothing more than an attempt to “plead around” claims already being asserted by the Madoff trustee

⁴¹ *Id.* at ¶ 43. Ms. Murdoch, Ms. Batista Jiminez and Mr. Da Silva are no longer plaintiffs in the Oliveira Lawsuit. PIEC’s Response to Trustee’s Statement of Uncontested Facts at ¶ 38.

⁴² Trustee’s Statement of Uncontested Facts at ¶ 44.

and that the claims, despite being framed in non-bankruptcy legal terms, were derivative of the trustee's fraudulent transfer claims.

We have defined so-called “derivative claims” in the context of bankruptcy as ones that “arise[] from harm done to the estate” and that “seek [] relief against third parties that pushed the debtor into bankruptcy.” *Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC)* (“*JPMorgan Chase*”), 721 F.3d 54, 70 (2d Cir. 2013). In assessing whether a claim is derivative, we inquire into the factual origins of the injury and, more importantly, into the nature of the legal claims asserted. See *Johns–Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns–Manville Corp.)* (“*Manville III*”), 517 F.3d 52, 67 (2d Cir. 2008). While a derivative injury is based upon “a secondary effect from harm done to [the debtor],” an injury is said to be “particularized” when it can be “directly traced to [the third party’s] conduct.” *St. Paul Fire & Marine Ins. Co. v. PepsiCo, Inc.*, 884 F.2d 688, 704 (2d Cir. 1989).

Madoff II, 740 F.3d at 89.

Here, Mr. Darr wishes to sue recruiting participant Net Winners on theories of fraudulent and preferential transfer to recover money for the benefit of all the Telexfree victims. The defendants, a class of victims, seek to recover the same monies arising out of the same transactions based on a theory of unjust enrichment. They are in direct competition with the trustee. Viewed through the prism of bankruptcy law and policy, their claims are derivative of those asserted by Mr. Darr.

Recommended Ruling

For the reasons set forth above, I recommend granting Mr. Darr's motion for summary judgment and denying the PIEC's.

At Boston, Massachusetts this 18th day of December, 2017.

By the Court,



Melvin S. Hoffman
U.S. Bankruptcy Judge

Counsel Appearing: Harold B. Murphy, Esq.
Charles R. Bennett, Jr., Esq.
Murphy & King, Professional Corporation
Boston, MA
for Stephen B. Darr, Chapter 11 trustee, plaintiff

William R. Baldiga, Esq.
Brown Rudnick LLP
Boston, MA, and
Robert J. Bonsignore, Esq.
Bonsignore, PLLC
Las Vegas, NV
for the PIEC

Ilyas J. Rona, Esq.
Milligan Rona Duran & King LLC
Boston, MA
for Frantz Balan, class representative
Amicus curiae

