FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FEDERAL TRADE COMMISSION, Plaintiff-Appellee, v. BURN LOUNGE, INC., a Corporation; JUAN ALEXANDER ARNOLD, an individual, Defendants-Appellants, and JOHN TAYLOR, an individual; ROB DEBOER, an individual, Defendants.	No. 12-55926 D.C. No. 2:07-cv-03654-GW-FMO
FEDERAL TRADE COMMISSION, individual, Defendants,	No. 12-56197 D.C. No. 2:07-cv-03654-GW-FMO

Before: Harry Pregerson, Marsha S. Berzon, and Morgan Christen, Circuit Judges.

Opinion by Judge Christen

SUMMARY *

Federal Trade Commission

The panel affirmed the district court's order granting a permanent injunction against Burn Lounge, Inc.'s continued operation based on the court's holding that Burn Lounge's multi-level marketing business was an illegal pyramid scheme in violation of § 5(a) of the Federal Trade Commission Act.

Burn Lounge operated a multi-level marketing business that offered participants the ability to become "Independent Retailers" of music and other merchandise. Independent Retailers could earn points redeemable for music or merchandise, or they could pay an additional fee to become "Moguls" and earn cash rewards.

The panel held that Burn Lounge's scheme satisfied both prongs of the Webster v. Omnitron International, Inc., 79 F.3d 776 (9th Cir. 1996), pyramid scheme test because Moguls paid for the right to sell products, the rewards Burn Lounge paid were primarily for recruitment, and Moguls were clearly motivated by the opportunity to earn cash

* This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

rewards from recruitment. The panel also held that the district court did not abuse its discretion in admitting the Federal Trade Commission's expert testimony because the testimony was relevant and reliable.

COUNSEL

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No appearance for Defendant/Cross-Appellee Robert Bruce.

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M. Jeffrey Hanscom and Joseph Mariano, Direct Selling Association, Washington, D.C.; Deborah T. Ashford, Philip C. Larson, and Catherine E. Stetson, Hogan Lovells US LLP, Washington, D.C., for Amicus Curiae Direct Selling Association.

OPINION

CHRISTEN, Circuit Judge

also hold that the district court did not abuse its discretion by admitting Vander Nat's testimony because his testimony was relevant and reliable. Accordingly, we affirm on these issues. We discuss the district court's consumer harm calculation and the FTC's cross-appeal in a separate memorandum disposition.

I. BACKGROUND

BurnLounge operated from 2005 to 2007 and sold music, music-related merchandise, and packages of music-related merchandise. Customers could participate in BurnLounge in three ways: they could buy music and merchandise; they could buy a package to become an Independent Retailer with the ability to earn credits redeemable for music and merchandise; or they could buy a package and pay an additional fee to become a Mogul with the ability to earn credits redeemable for cash. In 2007, the FTC commenced this action and the parties stipulated to a preliminary injunction that prohibited BurnLounge from continuing to operate its Mogul program. After a bench trial, the district court concluded that BurnLounge and the individual defendants had violated FTCA § 5(a), issued a permanent injunction, and imposed monetary awards against the defendants.

A. BurnLounge's Business

1. The basics of BurnLounge

The evidence at trial showed that BurnLounge's business had two primary aspects—its Retailer program and its Mogul program. Individuals could become Independent Retailers of online music by purchasing one of BurnLounge's three

packages: Basic ($29.95 per year); Exclusive ($129.95 per year plus $8 per month); or VIP ($429.95 per year plus $8 per month). Each package provided the Retailers with access to a ready made and customizable web page, called a "BurnPage."[1] A BurnPage was the vehicle through which Retailers sold music, music-related merchandise, or packages of music-related merchandise to customers in return for "BurnRewards." More expensive packages included more merchandise for personal use by the Retailer.[2] Individuals who participated as Retailers could redeem BurnRewards for music or merchandise.

Retailers could pay an additional monthly

2. BurnLounge bonuses

BurnLounge offered Moguls the opportunity to earn three types of BurnRewards bonuses that could be redeemed for cash. Each type of bonus had a separate set of requirements that had to be met before Moguls were eligible to receive the bonus.

a. Concentric Retail Bonuses

Moguls received "Concentric Retail Bonuses" for music, merchandise, and package sales made through their own BurnPage and through the BurnPages of their downline recruits. Downline recruits included participants recruited by Moguls and those recruited by earlier recruits. This sequence created a hierarchy with those whom a Mogul directly recruited in the first "Ring" of the hierarchy those whom the recruits recruited in the second Ring of the hierarchy and so on, for up to six Rings. To qualify for a Concentric Retail Bonus for sales made by recruits in each Ring of the hierarchy a Mogul had to sell at least the number of packages corresponding to that Ring number. For example, to qualify for Concentric Retail Bonuses for sales made by recruits in the fourth Ring, a Mougl had to sell at least four packages. The Mogul also had to have made a certain number of music album sales in the previous month, and the Mogul's hierarchy must have made a certain number of album sales in the previous month.

b. Product Package Bonuses

Moguls received "Product Package Bonuses" for selling product packages. Moguls received these bonuses in increasing amounts for the sale of Basic, Exclusive, and VIP

B. District Court Proceedings

After a bench trial, the district court issued a statement of decision. It provides a comprehensive review of BurnLounge's merchandise, bonus system, and advertising materials. The district court described BurnLounge's bonus system as "a labyrinth of obfuscation." It found there was a 93.84% failure rate for all Moguls, meaning 93.84% of Moguls never recouped their investment. The district court also found that BurnLounge's marketing focus was on recruiting new participants through the sale of packages. The district court ruled that BurnLounge's expert, David Nolte, provided estimated values of the merchandise in the BurnLounge packages that were not credible or supported by the evidence. It found that BurnLounge's products had some value, but concluded that the evidence did not support a finding that the products were worth what was charged for them.

The district court found that because purchasing a package was required for participation as a Retailer or Mogul, and because Moguls earned cash for selling packages, "[Moguls] by default received compensation for recruiting others into the program." The district court concluded that "a majority of the BurnLounge business (consisting of the Mogul program and related elements) was a pyramid scheme."

II. STANDARD OF REVIEW

We review a district court's findings of fact after a bench trial for clear error. See Fed. R. Civ. P. 52(a)(6); Allen v. Iranon, 283 F.3d 1070, 1076 (9th Cir. 2002). Under this de` (,,ve6ed-pert,

findings of fact unless we are left with the definite and firm conviction that a mistake has been committed." Allen, 283 F.3d at 1076. We review the district court's conclusions of law de novo. FTC v. Garvey, 383 F.3d 891, 900 (9th Cir. 2004). We review the district court's decision to admit expert testimony for abuse of discretion. Gen. Elec. Co. v. Joiner, 522 U.S. 136, 143 (1997).

III. DISCUSSION

In Webster v. Omnitrition International, Inc., our court approved the FTC's test for determining whether a multi-level marketing (MLM) business is a pyramid scheme: a pyramid scheme is "characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users." 79 F.3d 776, 781 (9th Cir. 1996) (quoting Koscot, 86 F.T.C. at 1180). Not all MLM businesses are illegal pyramid schemes. To determine whether a MLM business is a pyramid, a court must look at how the MLM business operates in practice. See id. at 783–84; see also United States v. Gold Unlimited, Inc., 177 F.3d 472, 479–82 (6th Cir. 1999); In re Amway Corp., 93 F.T.C. 618, 716 (1979).

A. Prong 1: Participants in the BurnLounge business paid mo

to sell a product," which satisfies the first prong of Omnitrition. 79 F.3d at 781 (citation omitted).

B. Prong 2: BurnLounge participants paid money in

recruitment and that the rewards it paid, in the form of cash bonuses, were primarily for recruitment rather than for sales of merchandise. Recruiting was built into the compensation structure in that recruiting led to eligibility for cash rewards, and more recruiting led to higher rewards. For example, Moguls could not convert their rewards to cash until they became qualified Moguls, and Moguls had to sell two premium packages to become qualified. Selling packages was a way of recruiting new Moguls—in fact, it was the only form of recruitment—because purchasing a package was necessary to become a Mogul and earn cash rewards. Also, 96.8% of the participants who bought packages became Moguls, which is strong evidence that package purchases were motivated by the opportunity to earn cash.

Moguls were required to sell packages to receive Concentric Retail Bonuses at each level of their downline hierarchy. Product Package Bonuses were cash rewards received for selling packages to new members. Moguls received more lucrative bonuses if they sold premium packages. Moguls were also eligible to receive Mogul Team Points, with the goal of receiving Mogul Team Bonuses. Mogul Team

supports the district court's finding that Moguls had a strong incentive to recruit new participants. This incentive was the danger our court warned of in Omnitrition, where we stated, "The promise of lucrative rewards for recruiting others tends to induce participants to focus on the recruitment side of the business at the expense of their retail marketing efforts, making it unlikely that meaningful opportunities for retail sales will occur." Omnitrition, 79 F.3d at 782 (citing Koscot, 86 F.T.C. at 1181).

That BurnLounge motivated Moguls through cash rewards earned by recruiting other participants is exemplified by the sharp difference between Moguls' and non-Moguls' package purchase patterns. BurnLounge's own data showed that 67% of Moguls bought VIP packages, 28.8% bought Exclusive packages, and just 4.2% bought Basic packages. In contrast, 17.3% of non-Moguls bought VIP packages, 17.2% bought Exclusive packages, and 65.5% bought Basic packages. If package purchases were driven by the value of the merchandise included in the packages rather than by the opportunity to earn cash rewards, one would expect to see comparable numbers of Moguls and non-Moguls buying the same packages. Further, 96.6% of non-Moguls (56,017 people) did not purchase any of the packages at any time—they just bought music and other merchandise.

The district court's finding that BurnLounge paid rewards for recruitment unrelated to product sales is also supported by the effect the preliminary injunction had on BurnLounge's revenues. After the parties entered into a stipulated preliminary injunction in July 2007 that stopped BurnLounge from offering the ability to earn cash rewards, BurnLounge's revenues plummeted. BurnLounge still offered packages, but its revenues decreased from $476,516 in June 2007 to

$10,880 in August 2007. The dramatic decline in revenue after the ability to earn cash rewards was eliminated provides further evidence that the sale of BurnLounge packages was primarily directed at participants who were interested in the Mogul program, where it was possible to earn cash rewards.

Recruiting and rewards for recruitment were integral to BurnLounge's business structure, and there was ample evidence that Moguls were meant to be, and were, primarily motivated by the opportunity to earn cash rewards for recruitment. As in Omnitrition, the evidence in this case shows that BurnLounge's "focus was in promoting the program rather than selling the products" Omnitrition, 79 F.3d at 782 (emphases in original). The district court did not err by holding that BurnLounge was an illegal pyramid scheme.

1. The *Omnitrition* test does not require that the rewards be completely unrelated to the sale of products.

BurnLounge argues that the second prong of the Omnitrition test "requires that the rewards be completely unrelated to sales of bona fide products." The second prong of the pyramid test requires the FTC to show that the scheme provides "the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users." Id. at 781 (citation omitted). This test does not require that rewards be completely unrelated to product sales, and BurnLounge provides no support for its argument that the test should be interpreted this way

First, reading "completely" into the test would be inconsistent with the outcome in Omnitrition. See id. at 782 (holding Omnitrition was likely a pyramid scheme because of its recruitment focus, notwithstanding the fact that Omnitrition made some retail sales).

Second, courts applying the Koscot/Omnitrition test have consistently found MLM businesses to be illegal pyramids where their focus was on recruitment and where rewards were paid in exchange for recruiting others, rather than simply selling products. See Gold Unlimited, 177 F.3d at 476, 481 (affirming conviction based on finding that participants bought gold and received cash payments for recruiting others to both buy gold and recruit others to do so, because rewards were paid for recruitment rather than product sales); Stull v. YTB Int'l, Inc., No. 10-600-GPM, 2011 WL 4476419, at *4–5 (S.D. Ill. Sept. 26, 2011) (denying motion to dismiss where plaintiffs adequately alleged that pyramid existed by showing focus on recruitment and payment of rewards in return for product sales, because buying the product was synonymous with being recruited into the scheme); FTC v. Equinox Int'l Corp., VC-S-990969HDR (RLH), 1999 WL 1425373, at *6 (D. Nev. Sept. 14, 1999) (ordering preliminary injunction after finding Equinox was likely a pyramid because "

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Such an outcome would be clearly contrary to our case law: a pyramid scheme "cannot save itself simply by pointing to the fact that it makes some retail sales." Omnitrition, 79 F.3d at 782.

The rewards BurnLounge paid were primarily for recruitment, not for the sale of products. Because the outcome in this case is clear under the Omnitrition test, we do not need to decide the degree to which rewards would need to be unrelated to product sales in a case presenting a closer question.

2. The meaning of "ultimate users."

BurnLounge also argues "that the existence of internal consumption (in this case a Mogul's purchase of a product package for use, not resale) does not constitute proof of ad

In Koscot, the FTC found a cosmetics MLM business was a pyramid scheme because it focused on recruiting new participants, rather than encouraging retail sales to consumers, and new participants had to buy large amounts of inventory, ostensibly for resale. 86 F.T.C. at 1179. When participants in Koscot bought inventory, they could have used some of it personally arguably making them "ultimate users." In Amway, though some internal consumption of inventory was common, Amway was not found to be an illegal pyramid scheme. See Amway, 93 F.T.C. at 716–17, 725 n.24. BurnLounge is correct that when participants bought packages in part for internal consumption (to obtain the ability to sell music through BurnPages and to use the package merchandise), the participants were the "ultimate users" of the merchandise and that this internal sale alone does not make BurnLounge a pyramid scheme. But it is incorrect to conclude that a` ` F@ to exclude that t À µ@ ™(Ö–æ6÷'&V7B

1999 WL 1425373, at *6; Holiday Magic, 84 F.T.C. at 1028–32; Peterson, 48 P.3d at 930.

Burn Lounge and Arnold cite a passage from an FTC advisory letter, Exhibit 3 at trial, to argue that proof of internal consumption does not establish that Burn Lounge was a pyramid. Read in its entirety, the relevant passage of the letter is consistent with the district court's analysis. The relevant passage reads:

> Much has been made of the personal, or internal, consumption issue in recent years. In fact, the amount of internal consumption in any multi-level compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme. The critical question for the FTC is whether the revenues that primarily support the commissions paid to all participants are generated from purchases of goods and services that are not simply incidental to the purchase of the right to participate in a money-making venture.

As discussed above, the rewards Burn Lounge paid to Moguls were primarily in return for selling the right to participate in the money-making venture—the Mogul program. The merchandise in the packages was simply incidental.

The district court correctly applied the Omnitrition test and its conclusion that

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VanderNat's testimony was relevant because he testified about whether BurnLounge was a pyramid and about the amount of consumer harm. His testimony was also reliable given his doctorate in economics and advanced degree in mathematics, which he called on to interpret BurnLounge's sales data; his previous experience analyzing pyramids; his previous experiences testifying in court in five similar cases and providing expert deposition testimony in seven similar cases; his published article on the difference between pyramids and legal MLMs; and his personal experience spending several weeks analyzing BurnLounge's business model.

BurnLounge and Arnold argue that the district court's reliance on Vander Nat's mathematical projections and formulas was an abuse of discretion because "Ger-Ro-Mar teaches that the math is not itself sufficient." BurnLounge's reliance on Ger-Ro-Mar, Inc. v. FTC, 518 F.2d 33 (2d Cir. 1975), is misplaced. In that case the Second Circuit found that the FTC "relied solely upon an abstract mathematical theorem without any attempt to relate the theory to the marketplace." Id. at 38. Here, the FTC used VanderNat's analysis of BurnLounge's own data to show how BurnLounge's business worked in practice. BurnLounge's data convincingly illustrated the disproportionate rate at which Moguls were motivated by the chance to earn cash rewards rather than the merchandise BurnLounge included in the packages. VanderNat was qualified to testify and it was proper for the district court to decide that his testimony would be helpful to the trier of fact (here the court). See Daubert, 509 U.S. at 591–92.

BurnLounge and Arnold also argue that VanderNat did not base his analysis on the definition of "pyramid" accepted

IV. CONCLUSION

We affirm the district court's holding that BurnLounge was an illegal pyramid scheme, in violation of § 5(a) of the FTCA. BurnLounge's scheme satisfied both prongs of the Omnitrition test because Moguls paid for the right to sell products, the rewards BurnLounge paid were primarily for recruitment, and Moguls were clearly motivated by the opportunity to earn cash rewards from recruitment. We reject the argument raised by BurnLounge and Arnold that the district court abused its discretion when it admitted Vander Nat's testimony because the testimony was relevant and reliable. The district court's decision as to these two issues is AFFIRMED. [7]

[7] We discuss the district court's consumer harm calculation and the FTC's cross-appeal in a separate memorandum disposition.