12-55926, 12-56197 and 12-56288 (Consolidated)

IN THE
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FEDERAL TRADE COMMISSION,
Plaintiff-Appellee

v.

BURNLOUNGE, INC., JUAN ALEXANDER ARNOLD, AND JOHN TAYLOR,
Defendants-Appellants

and

ROB DEBOER,
Defendant

On Appeal from the United States District Court
for the Central District of California
No. 2:07-03654 – Honorable George Wu

SECOND CROSS-APPEAL AND ANSWERING BRIEF OF PLAINTIFF-APPELLEE FEDERAL TRADE COMMISSION

Of Counsel

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ISSUES PRESENTED

1. Illegal pyramid scheme: Whether the district court correctly determined that BurnLounge was an illegal pyramid scheme, where the evidence showed that the company's revenue and commissions relating to recruitment far outweighed those relating to the sale of digital music – its ostensible product – and that 93.84% of those recruited did not recover even their initial investment.

2. Admission of expert testimony: Whether the district court abused its discretion in admitting during a bench trial the testimony of Dr. Peter Vander Nat, an FTC economist and mathematician with extensive experience in analyzing pyramid schemes.

3. Equitable monetary relief: Whether the district court abused its discretion in ordering BurnLounge to disgorge $16 million of funds paid to it by consumers.

4. Individual liability: Arnold: Whether the district court abused its discretion in finding Juan Alexander Arnold liable for equitable monetary relief where the evidence showed that he had the requisite participation and knowledge.

5. Individual liability: DeBoer (FTC Cross-Appeal No. 12-56228): Whether the district court abused its discretion in finding Robert DeBoer individually liable but allowing him credit for his expenses and sales of music connected with the illegal pyramid scheme.

[2] Citations to docket entries from the district court record are in the form "Dkt. ___." Citations to exhibits are in the form "Ex. __." Citations to the Excerpts of Record are cited as "ER" and citations to the Supplemental Excerpts of Record are cited as "SER." Citations are to Bates page numbers or ECF header page numbers where available. Finally, citations to the trial transcript will follow the district court's convention and identify the witness, volume, and page number. See Dkt. 385.

[3] The complaint named a fourth defendant, Scott Elliott. Elliott entered into

make substantial income from BurnLounge, and (3) defendants failed to disclose that most participants were not likely to make substantial income. Dkt. 1. Defendants BurnLounge and Arnold filed motions for summary judgment which were denied on November 10, 2008. Dkt. 351 [83 ER]. The case proceeded to a nine-day bench trial from December 9 to 22, 2008, during which the court received testimony from 28 witnesses.

The court issued its Statement of Decision on July 1, 2011, finding for the FTC on all counts. Dkt. 431 [5 ER]("Decision"). The court entered final judgment on July 25, 2011, ordering injunctive relief and equitable monetary relief in the following amounts: BurnLounge and Arnold, $16,245,799.70; Taylor, $620,139.64; DeBoer, $150,000. Dkt. 437.

Defendants filed objections to the form of the judgment, challenging several specifications relating to the injunctive relief. Dkt. 438. After additional briefing and hearings, on March 1, 2012, the court entered an amended final judgment and order that affirmed the earlier relief with

On March 29, 2012, defendants Blu Lounge and Arnold filed a motion to alter or amend judgment under Fed. R. Civ. P. 59, alleging that the court had erred in its calculations of equitable monetary relief. Dkt. 477 [10 ER]. The court denied the motion on May 3, 2012. Dkt. 488 [2 ER]. These appeals followed.

B. Facts and proceedings below

1. Introduction

This case presents the old problem of pyramid schemes in the new context of online music sales. A pyramid scheme o

additional salespeople through the sale of "packages." These packages were essentially fees for the opportunity to participate, although they were accompanied by different collections of ancillary items, such as music downloads, magazines, or DVDs. The FTC showed that, under the best circumstances, at least 87.5% of BurnLounge participants would not recoup their initial investment, i.e., the money they paid to BurnLounge primarily for the purchase price of these "packages." BurnLounge's own sales data corroborated this and showed the actual failure rate was closer to 94%. Defendants never disclosed this colossal failure rate to participants. Instead, they falsely claimed that participants could earn six- or seven-figure incomes. Ultimately, over 60,000 people accepted this vaunted opportunity, suffering losses of $21.4 million.

2. BurnLounge Background

The defendants in the case are BurnLounge; Arnold, BurnLounge's founder and CEO; Taylor, Arnold's "right-hand man" and "Retailer 001" at the top of the pyramid; and DeBoer, one of BurnLounge's most prominent and successful salesmen. Taylor, 4 RT 124 [6 SER 020], 5 RT 22 [7 SER 026]; DeBoer, 6 RT 35-37 [8 SER 032-34]; Arnold, 6 RT 142-43 [9 SER 054-55]; Dkt. 353-2 at 3 [82 ER 1090].

BurnLounge operated from late 2005 until June 2007, when the FTC

commenced this lawsuit and the parties agreed to a stipulated preliminary injunction. Dkt. 49 [89 ER]; Ex. 353-2 at 3-4 [82 ER 1090-91]. Describing itself as a combination of MySpace, iTunes, and Amway, the company operated in two aspects.[4] See, e.g., Dkt. 417, at 3.

First, BurnLounge offered consumers the opportunity to become independent retailers selling digital music online. Consumers did so by purchasing a BurnLounge package at one of three price levels: Basic, for $29.95; Exclusive, for $129.95; or VIP, for $429.95. Ex. 10 at 2-3 [55 ER 0686-87].[5] Each of these packages provided a webpage (or "BurnLounge") that served as an online store and software for retailers to market and sell digital music and other music-related paraphernalia licensed and provided by BurnLounge. Id. In doing so, retailers earned points, known as BurnRewards points, that they could redeem for their own music and merchandise. Id. at 4 [55 ER 0688]. Each package also included additional promotional items. The Basic package offered the fewest items, while

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[4] This discussion of BurnLounge's operations is taken largely from Exhibit 8, "Statement of Policies and Procedures," Dec. 18, 2006 [56 ER], and Exhibit 10, "Shared Compensation Plan," Nov. 2006 [55 ER]. These documents are described collectively as BurnLounge's "compensation plan."

Defendants claim the trial judge erroneously ignored earlier versions of the compensation plan. BurnLounge Br. 23-24 & n.10, 64; Taylor Br. 12. As discussed below, these claim are unavailing. See Argument, III.B.2., infra.

[5] Participants paid additional monthly dues of $8 for the Exclusive and VIP packages. Ex. 10 at 3 [55 ER 0687].

the VIP package included, among other things, a magazine subscription, special event passes, music downloads called "BurnLounge Presents," and a DVD set called the "BurnLounge University."[6] Id. at 2-3 [55 ER 0686-87]; Dkt. 353-2 at 4-5 [82 ER 1091-92]. These items were developed by BurnLounge; none had ever been offered outside of the packages.

Second, BurnLounge offered retailers the business opportunity to become Moguls for an additional $6.95 per month. Ex. 10 at 3-4 [55 ER 0687-88]. Retailers who became Moguls could redeem their BurnRewards points for cash, at the rate of $1 for 1 BurnRewards point. Ex. 10 at 4 [55 ER 0688]. Critically, Moguls were also eligible to earn bonuses for selling packages to other consumers and thereby recruiting them to become retailers. The illegal pyramid scheme arises from the Mogul program and compensation plan.

3. Bonuses

BurnLounge offered multiple types of bonuses and rewards. The structure of these bonuses steered participants to become Moguls and buy and sell the most expensive VIP package, thereby recruiting others and developing the pyramid. To be eligible to receive these bonuses or rewards in cash, a participant needed to

[6] Though the items included with the packages changed during BurnLounge's operation, the prices of the packages did not change. Ex. 353-2 at 4-5 [82 ER 1091-92].

[7] These points are known as “Mogul Points” and are different from the

8 [55 ER 0692]; Ex. 8 at 30-31 [56 ER 0724-25].

Whenever a Mogul balanced 300 points – meaning that she had 300 points or more on both her A-team and her B-team – the Mogul earned a cash bonus.[8] Ex. 10 at 9 [55 ER 0693]; Ex. 8 at 30-31 [56 ER 0724-25].

The calculation of these bonuses varied depending upon the type of package the Mogul herself had initially purchased. For Moguls who had invested over $400 by buying a VIP package, the bonus amount for each 300-point balance was $50. For Moguls who bought the less expensive Exclusive package, the bonus was only $25, unless the Mogul also sold at least $500 worth of music.[9] If so, then the bonus amount was $50. Moguls who bought a Basic package were not eligible to earn bonuses at all, except in the (unlikely) event that they sold $500 worth of music, in which case they could theoretically earn a $25 bonus. If the Basic Mogul sold $1000 worth of music, then the Mogul could earn a $50 bonus. Ex. 10 at 7-8 [55 ER 0691-92]; Ex. 8 at 30-31 [56 ER 0724-25].

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[8] This bonus was also known as a "level bonus," because it could be earned repeatedly as the Mogul and her organization sold packages and generated points. See, e.g., Ex. 43 at 1169 [21 SER 171].

[9] There was no evidence showing that any Mogul sold at least $500 in music sufficient to increase the Mogul Team Bonus. Decision, 23-24 & n.39 [5 ER 0066-67]. In fact, the evidence showed that per capita music sales only totaled $26.80. Ex. 176 [25 SER 185] ($1,607,979.56 in music sales); Ex. 422 [42 ER] (60,270 Moguls).

[10] Indeed, retailers were advised to have their spouses buy albums as a painless way of meeting these requirement

b. Concentric Retail Rewards

As structured, the Concentric Retail program was opaque, onerous, and not nearly as lucrative as the Mogul Team Bonuses. See, e.g., Vander Nat, 8 RT 93-94 [11 SER 091-92]; Ex. 369 [34 SER]. For these reasons, Concentric Retail rewards were dwarfed by Mogul Team Bonuses. For example, in 2006, BurnLounge paid over $9 million in Mogul Team and Product Package Bonuses, but only $2.7 million in Concentric Retail rewards. Ex. 258 at D0013677 [30 SER 196].

And, because Moguls could earn Concentric Retail rewards for package sales, the overwhelming amount of the rewards paid related to packages, not music. During its operation, BurnLounge paid over $3.7 million in Concentric Retail rewards for package sales, but only paid $161,500 in Concentric Retail rewards for music sales. Vander Nat, 11 RT 86 [14 SER 139]; Ex. 247 [27 SER].

Thus, the Concentric Retail program to promote the sale of music actually reinforced package sales and recruitment.[12] The FTC's expert testified that, in the time a Mogul could earn $277,006 in Concentric Retail rewards, she would have earned over $1.86 million in Mogul Team Bonuses. Vander Nat, 8 RT 123-27 [11 SER 093-97]; Vander Nat Decl., 46-47 [ER 1286-87]; Ex. 371 [35 SER]. And of this $277,006 reward, only $25,217, or less than 10%, actually related to the sale

[12] The program also reinforced recruitment because a Mogul had to be qualified to earn rewards and qualification required the Mogul to sell at least two premium packages. Ex. 10 at 4, 7-8 [55 ER 0688, 0691-92].

See BurnLounge's Promotion and Marketing

meetings around the country.[13] Decision, 17-19 & n.32 [5 ER 0060-62]; Taylor, 4 RT 126 [6 SER 021], 5 RT 46-47 [7 SER 027-28]; DeBoer, 6 RT 35 [8 SER 032]; Arnold, 7 RT 62 [10 SER 062].

Another aspect of this promotion and marketing was a marked focus on the VIP package. Moguls were encouraged to sell it, and interested participants were encouraged to buy it, to generate lucrative rewards. See, e.g., Ex. 43, at 1169-70 [21 SER 171-72]; Vander Nat Decl., ¶ 13 [90 ER 1253-58] (reviewing various marketing materials). This promotion served to reinforce the bonus structure, and through it, the pyramid.

5. Results and Harms to Consumers

BurnLounge's structure and marketing resulted in sharp contrasts between Moguls and non-Moguls. BurnLounge's sales data showed that Moguls – those retailers who wanted to convert BurnPoints to cash and who paid the monthly $6.95 Mogul fee – overwhelmingly preferred to buy the premium Exclusive and VIP packages. Out of 60,270 Moguls, 67% (or 40,393) bought VIP packages, 28.8% (or 17,359) bought Exclusive packages, while only 4.2% (or 2,518) bought Basic packages. Ex. 422 [42 ER]. The data showed the opposite for

[13] Contrary to his assertion that false income claims were only presented to a total of 590 people, Taylor Br. 21, Taylor admitted at trial that he made earnings claims all over the country, including at a single event in Las Vegas with 2,500 attendees. Taylor, 4 RT 126-28 [6 SER 021-23], 5 RT 46 [7 SER 027].

highest rewards possible within the scope of the plan; and (4) the company's sales data, to compare actual performance to the optimal model. Vander Nat, 8 RT 44-45, 53-54 [11 SER 074-77]; see generally Vander Nat Decl. [90 ER].

Dr. Vander Nat's optimal scenario demonstrated that a Mogul needed a sales organization with at least three levels below her in order to recoup her initial investment. Under an optimal scenario, Dr. Vander Nat assumed the Mogul would purchase a VIP package since this offered the fastest and easiest way to generate bonuses, and thus would invest $450 (the basic cost of the VIP package plus dues and taxes). A Mogul with three levels below her would receive bonuses totaling $550 and recoup this $450. But Moguls with fewer than three levels below them would not. And, mathematically, the lowest three levels in a binary sales organization comprise 87.5% of the sales force, meaning that, under the best of circumstances, at least 87.5% of BurnLounge's Moguls would not recoup their initial investment. Moreover, this optimal failure rate did not change regardless of the number of Moguls. As Dr. Vander Nat demonstrated, no matter how large the organization, or how many levels, the bottom three always comprise at least 87.5% of the participants.[15] Vander Nat, 8 RT 60-69, 111 [11 SER 078-87]; Vander Nat Decl.,

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[15] This 87.5% figure assumes that the pyramid has at least 10 levels, which BurnLounge did. For pyramids with fewer than 10, the optimal failure rates are actually higher. Vander Nat Decl., 27 n.19, 50 [90 ER 1267, 1290].

24-27 [90 ER 1264-67]; Ex. 365 [32 SER]; Ex. 418 [37 SER].

Comparing the optimal scenario to BurnLounge's sales data showed that the actual failure rate was even worse. Dr. Vander Nat calculated each Mogul's net position by simply comparing the total payments made by the Mogul to BurnLounge against the total commissions and bonuses paid by BurnLounge to the Mogul. He found that, of the 60,270 moguls, 56,557 – 93.84% – had a net return of $0 or less. The data further showed that the rewards payments skewed heavily towards the top levels of the organization, with the top 6% of earners taking 85% of the rewards and bonus payments, while the top 1% earned 66%. Vander Nat, 9 RT 6-21 [12 SER 098-113]; Ex. 421 [38 SER].

Moreover, Dr. Vander Nat's optimal scenario also demonstrated that the BurnLounge rewards program was unsustainable. Assuming that the sales force was limited to ten layers and that every participant maximized their return, the sales force would generate $40,720 in all sales revenue. Vander Nat, 8 RT 71-

28-30 [90 ER 1268-70]; Ex. 365 [32 SER].[16]

Dr. Vander Nat calculated the extent of the consumer harm caused by BurnLounge. By adding the net payments made by all those Moguls whose lost money and subtracting out the bonuses and other rewards they received, he concluded that Moguls lost nearly $21 million to BurnLounge. Vander Nat, 9 RT 31 [12 SER 115].

As Dr. Vander Nat testified, this harm calculation did not include any value from the items included with the packages because it was impossible to value separately items that were bundled and that had never been sold independently. Vander Nat, 9 RT 30 [12 SER 114]. More importantly, he testified that he used the decision to become a Mogul as an indicator of a given individual's motivation to buy a BurnLounge package for the business opportunity. Vander Nat, 9 RT 30-32 [12 SER 114-16].

Dr. Vander Nat's assessment of the items' value was confirmed by BurnLounge's decision in June 2007 to end its multilevel marketing and offer the packages without the Mogul business opportunity. Dkt. 353-2 at 4 [82 ER 1091].

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[16] BurnLounge claims that its revenues were sufficient to sustain the commissions paid and it points to supporting testimony from its CFO and its statements of operations from 2005 to 2007. BurnLounge Br. 25. But as that testimony and those statements show, BurnLounge always lost millions when all of the company's expenses were included. Piemonte, 14 RT 154-57 [17 SER]; Ex. 66 [53 ER]; Ex. 64 [54 ER].

Revenues plummeted, from $476,516 in June 2007 to $15,270 in July 2007 and to $10,880 in August 2007. Decision, 9, 16 [5 ER 0052, 0059] (citing Ex. 67 [23 SER] (June); Ex. 65 [22 SER] (July); Ex. 68 [24 SER] (August)). This collapse showed that consumers were not interested in the packages or their items without the business opportunity.

6. Trial

The case proceeded to trial in December 2008. The FTC presented 16 witnesses, including consumers who had been Moguls, and 6 FTC employees who had observed and recorded various BurnLounge presentations. The FTC also called defendants, Arnold, Taylor, and DeBoer. Finally, the FTC called Dr. Vander Nat as its expert witness. Dkts. 367-73.

In turn, the defendants called 12 witnesses. These witnesses included several BurnLounge executives and retaile

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item to supposedly similar items available for sale. Nolte, 14 RT 179-81 [61 ER 0872-74]. On cross-examination, however, Nolte admitted that he had never valued an Internet store like BurnLounge before. Nolte, 16 RT 9-10 [19 SER 153-54]. He admitted that he had never valued individual issues of magazines. Nolte, 16 RT 24-27 [57 ER 0752-55]. With respect to the DVD set included with the VIP package, Nolte admitted he had not valued either BurnLounge's DVDs or the disc sets he compared it to, but instead relied on outlines prepared by others. Nolte, 16 RT 16-23 [19 SER 155-62]. And he admitted that viewing the objects to be valued, as well as the objects of comparison, was part of a typical assessment. Nolte, 16 RT 20-23 [19 SER 159-62].

In turn, Luce, a lawyer and former President of the Direct Sales Association ("DSA"), the trade association for multilevel marketing ("MLM") companies, testified about MLMs and compensation plans, his interpretations of pyramid law, and the application of this law to BurnLounge. See generally Luce, 16 RT 49-128. Luce testified, for instance, that he believed the percentage of individuals who join MLMs for reasons other than income ranged as high as 40-60%. Luce, 16 RT 73-75 [57 ER 0770-72].

7. The Court's Decision

The district court issued its Statement of Decision on July 1, 2011.

Describing BurnLounge's compensation plan as more of a "labyrinth of obfuscation rather than a readily understood compensation system[,]" Decision, 10 [5 ER 0053], the court discussed in detail BurnLounge's compensation plan, sales data and statistics, and marketing and promotional activities. Decision, 4-20 [5 ER 0047-63].

a. Count I: Pyramid Scheme

On the first count alleging that BurnLounge was an illegal pyramid scheme, the court agreed, stating:

> Both as designed and in execution, the BurnLounge enterprise resulted in a large return for a small percentage of the Moguls which was funded by the substantial losses (the failure to recoup their initial investments) of the vast majority of recruited participants.

Decision, 21-22 [5 ER 0064-65].

In reaching this conclusion, the court identified those aspects of the BurnLounge business opportunity that encouraged recruitment. The court quoted this Court for the principle that rewards for recruitment unrelated to retail sales was "the sine qua non" of a pyramid scheme. Decision, 20-21 [5 ER 0063-64] (citing Webster v. Omnitrition Int'l, 79 F.3d 776, 781 (9th Cir. 1996)). Applying this principle, the court found that BurnLounge's promotional materials, presentations,

As the court determined, the major problem was that Nolte performed a comparative valuation. But, as Dr. Vander Nat explained, and as the court accepted, it is impossible to value items that were never separately available to consumers. Decision, 6 n.9 [5 ER 0049] (citing Vander Nat, 9 RT 30-31 [12 SER 114-15]). Moreover, the court found that many of Nolte's comparisons "ma[de] no sense," such as when Nolte compared the 6-disc "BurnLounge University" DVD set with the 10-disc documentary film on jazz by acclaimed director Ken Burns. Decision, 9 [5 ER 0052].

The court nonetheless concluded that the items included with the packages were not completely worthless because value is subjective. Decision, 10 [5 ER 0053]. After reviewing the evidence, the court concluded that the items had "extremely limited value to some consumers . . . ." Decision, 23 [5 ER 0066] (emphasis in original); see also id. at 10 & n.16 [5 ER 0053] (describing this as "giving the benefit of the doubt to BurnLounge"). But, "[t]o individuals who considered the bundled products as merely incidental to the business opportunity, the Court finds the products were of no relevant value." Decision, 10 [5 ER 0053] (emphasis added).

b. Counts II and III: Misrepresentations and Omissions

On the second and third counts, the court found that BurnLounge and the

individual defendants made "misleading affirmative representations . . . and also failed to disclose material information . . . ." Decision, 24-25 [5 ER 0067-68].

The court also recognized that the statements were widely disseminated. It quoted statements made by Arnold, Taylor, and DeBoer in live and pre-recorded calls and presentations available nationwide. Decision, 17-19 & n.32 [5 ER 0060-62].

c. Consumer Harm

Having found for the FTC on all counts, the court then calculated the harm defendants inflicted on consumers. The court undertook a detailed analysis using BurnLounge's sales data (Ex. 330 [45 ER]) and Dr. Vander Nat's calculations (Ex.

same calculation for each of the premium package levels. The court found that 65.5% of Exclusive Moguls, and 82.7% of VIP Moguls would not have bought their packages but for the business opportunity and thus were harmed. Decision, 27 [5 ER 0070]. The court multiplied these rates against the Mogul populations for each package and the incremental cost for the package level and then added these figures together to reach a total consumer harm of $16,245,799.70. Id.

d. Individual Liability

The court ruled that Arnold should be jointly and severally liable for this amount. Applying FTC v. Publishing Clearing House, Inc., 104 F.3d 1168, 1170-71 (9th Cir. 1997), the court found that he had the requisite participation and knowledge because he created the Burn concept, served as a primary investor and shareholder, developed the compensation plan, and was the "boss" and the "ultimate authority." Decision, 28 [5 ER 0071]. The court's imposition of joint and several liability on Arnold was premised on the understanding that the FTC intended to use the funds it received to reimburse consumers. In the event the FTC did not undertake to repay consumers, the court alternatively ordered Arnold to disgorge his receipts in the amount of $1,664,566.45. Decision, 28 n.48 [5 ER 0071].

For Taylor, the court found that while he was not an officer or employee, he

was nonetheless deeply involved: Taylor helped raise capital, he was a shareholder, he was placed at the top of the pyramid as "Retailer 001," and he made material misrepresentations at BurnLounge events where he was introduced as Arnold's "right-hand man." Decision, 28 [5 ER 0071]. Based on this involvement, the court concluded that Taylor should be liable for $620,139.64, the amount he received from the scheme. Decision, 28-29 [5 ER 0071-72] (citing FTC v. Pantron I Corp., 33 F.3d 1088, 1102 (9th Cir. 1994)).

For DeBoer, the court acknowledged that he had participated in the scheme and had made misrepresentations, but it found that he had been an "effective . . . salesman," who could have been one of the victims. Decision, 29 [5 ER 0072]. The court also found that the FTC had not established the number of consumers who relied on DeBoer's statements or the amount of their losses. Id. Moreover, though it was "not disputed" that DeBoer received $908,293.69, the court allowed DeBoer credit for his expenses and for income from music sales he made outside of the pyramid scheme. Decision, 30 [5 ER 0073]. However, the court found that the FTC had not established what these figures were. The court then set DeBoer's disgorgement at $150,000.

8. Post-trial Proceedings

After the Statement of Decision and Order in July 2011, the court addressed

three separate post-trial motions from defendants. First, the court denied defendants' motion to strike Dr. Van der Nat's testimony, Dkt. 374 [65 ER], finding "no basis" to do so under *Daubert v. Merrill Dow Pharm.*, 509 U.S. 579, 592-93 (1993). Dkt. 450 at 1 [4 ER 0042]. Second, following defendants' objections, the court issued an amended final judgment that made minor changes to the final order and corrected clerical errors, but did not alter the court's conclusions. Dkts. 438, 473 [39 SER 7, 4 [3 ER]. The amended order did, however, alter the terms of Arnold's financial liability. To ensure that the FTC would implement any consumer redress program promptly, the amended judgment

STANDARD OF REVIEW

1. Findings of fact and conclusions of law. Following a bench trial, the trial judge's findings of fact are reviewed for clear error. FTC v. Garvey, 383 F.3d 891, 900 (9th Cir. 2004) (citing Zivkovic v. S. Cal. Edison Co., 302 F.3d 1080, 1088, (9th Cir. 2002)). The standard is "signi

complete justice[.]" FTC v. Stefanchik, 559 F.3d 924, 931 (9th Cir. 2009) (citing Pantron I Corp., 33 F.3d at 1102). A district court's decision to award equitable monetary or injunctive relief is a matter of discretion. Id. (citing Grosz-Salomon v. Paul Revere Life Ins. Co., 237 F.3d 1154, 1163 (9th Cir. 2001).

However, it is an abuse of discretion for a court to make an error of law; a court must identify and apply the correct legal rule and not overlook or misconstrue binding precedent. Perry v. Brown, 667 F.3d 1078, 1084 (9th Cir. 2012); United States v. Hinkson, 585 F.3d 1247, 1261-62 (9th Cir. 2009).

SUMMARY OF ARGUMENT

BurnLounge was an illegal pyramid scheme that caused losses of $21.4 million to over 56,000 consumers. After conducting a bench trial and receiving evidence that included expert testimony and BurnLounge's own compensation plan and sales data, the district court properly concluded that BurnLounge fits squarely within the definition of an unlawful pyramid applied by this Court and other tribunals. In both its marketing strategy and its compensation scheme, Burnlounge evinced the "recruitment focus" that this Court has recognized as the hallmark of a pyramid scheme. BurnLounge earned the great bulk of its income not from music sales, but from the sales of packages – particularly the expensive premium packages – that were essentially fees to participate in the money-making business

opportunity. Likewise, the primary rewards went not for music sales, but for the sale of yet more packages to more levels of participants. The inevitable result was that the vast majority of participants – nearly 94% – suffered substantial losses.

Defendants attempt to defend their program by characterizing the sales of packages to BurnLounge Moguls – including the expensive premium packages – as sales to "ultimate users" that take the program out of the pyramid mold. But this Court has held definitively that such internal sales do not exempt a business from the legal definition of a pyramid, and this Court may affirm on that ground alone. In any event, defendants' argument is soundly belied by the district court's detailed factual findings. The court conclusively rejected defendants' evidence for value in the packages, determined that their purchase patterns showed they were bought predominantly for the business opportunity, and found that the included items had "no relevant value" to Moguls who sought to earn cash for their recruiting efforts.

The district court properly admitted the testimony of Dr. Peter Vander Nat, an FTC economist and mathematician who is also one of the foremost experts on pyramid schemes. Dr. Vander Nat's testimony was highly relevant to the issue of whether BurnLounge was a pyramid. The testimony was also reliable, surviving vigorous cross-examination and opposing testimony from two other experts. Defendants' argument rests on a misunderstanding of pertinent law and on

mischaracterizations and distortions of Dr. Vander Nat's testimony.

The district court properly awarded injunctive and equitable monetary relief. Both the injunctive relief and equitable monetary relief were consistent with governing law. In calculating monetary relief, the court did not accept the FTC's proposed relief of $21.4 million, but developed its own figure from BurnLounge's sales data in order to give defendants "a generous

ARGUMENT

I. The court correctly determined that BurnLounge was an illegal

right, either by conditioning rewards on purchases of inventory or by requiring an "entry" or "headhunting" fee. *Amway*, 93 F.T.C. at 715-16, 1979 WL 198944, *69.

Pyramid schemes are inherently deceptive in violation of Section 5 because they represent that any individual can recoup his or her investment by means of inducing others to invest. *Koscot*, 86 F.T.C. at 1181, 1975 WL 173318, *60. This is deceptive because "the presence . . . of recruitment with rewards unrelated to product sales[] is nothing more than a elaborate chain letter device in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed." *Omnitrition*, 79 F.3d at 781-82 (quoting *Koscot*, 86 F.T.C. at 1180, 1975 WL 173318, *59). This recruitment focus ultimately leads to collapse because it cannot be sustained in the long term. 79 F.3d at 781 (citing *SEC v. Int'l Loan Network, Inc.*, 968 F.2d 1304, 1309 (D.C. Cir. 1992)).

To distinguish an illegal pyramid scheme from a legitimate MLM, a court must look at how the business functions in practice. *Whole Living, Inc. v. Tolman*, 344 F. Supp. 2d 739, 745 (D. Utah 2004) (citing *Omnitrition*, 79 F.3d at 783; *Amway*

and the percent of product sold compared with the percent of commissions granted." United States v. Gold Unlimited, Inc., 177 F.3d 472, 475 (6th Cir. 1999).

The court below correctly applied the facts it found to these cases to find that in practice BurnLounge was an illegal pyramid scheme. BurnLounge meets the Koscot definition precisely. See Koscot, 86 F.T.C. at 1180, 1975 WL 173318, *59. Through the packages, the company offered consumers "the right to sell a product," here, music and related merchandise. Through the Mogul program and its bonuses, BurnLounge offered "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." Moguls recruit by selling packages to others and encouraging them to become Moguls, too. The "rewards" for doing so are the cash payouts through the bonuses, the greatest of which were paid to those who bought and sold VIP packages – at a $400 premium over the Basic package. Decision, 21-24 [5 ER 0064-67]. And, as the court found, these awards were "clearly" unrelated to sales to ultimate users because the included items had "no relevant va -.0017 Tw .hR

cases. For one, BurnLounge received only $2.3 million in revenue from sales of music and merchandise, its ostensible products, but it received approximately $25 million – or more than 90% of its total revenue – from recruiting through sales of packages and related dues and fees. ER Decision, 16 [5 ER 0059] (citing Ex. 330 [45 ER]). Indeed, BurnLounge made $2.8 million in monthly $6.95 Mogul fees alone, more than in all music and merchandise sales combined. Id. Too, the rewards paid by BurnLounge were overwhelmingly related to sales of packages, not sales of music. As Dr. Vander Nat explained, in 2006, BurnLounge paid $8,480,975 in Mogul team bonuses and $680,458 in product package bonuses, both of which are based on package sales. In the same period, the company paid $2,726,965 in Concentric Retail rewards, but the vast majority of this was related to package sales as well. Vander Nat, 8 RT 126-27 [11 SER 096-97], 11 RT 72-74 [14 SER 135-37]; Ex. 258 at D0013677 [30 SER 196]. In sum, BurnLounge paid more than $17 million in commissions to its Moguls, a figure that dwarfs either revenues from or rewards paid for music sales. ER Decision, 16 [5 ER 0059] (citing Ex. 330 [45 ER]).

The stark contrasts in the purchase patterns of Moguls and non-Moguls further confirm that the participants understood that BurnLounge was primarily offering a business opportunity. Over 95% of Moguls – those interested in making

[18] This is why defendants' claim

For these reasons, the court's decision is consistent with other pyramid scheme cases. For instance, BurnLounge parallels Omnitrition because neither scheme provided sufficient incentives for participants to engage in retail sales. As this Court held, Omnitrition was not entitled to summary judgment on the pyramid claim because it could not show that its program tied recruitment to actual retail sales. 79 F.3d at 783-84. Similarly, BurnLounge's own sales data confirms that recruitment, not retail sales, was primary. Notably, the district court rejected defendants' claim that Omnitrition was different from BurnLounge because it involved "inventory-loading" – the practice of requiring participants to purchase quantities of merchandise to receive commissions. As the court found, this was a "distinction without a difference." Decision, 24 [5 ER 0067]. As the court recognized, the inventory-loading pyramid schemes condemned in prior cases were not illegal simply because of the purchasing requirements, but because the purchases were spurred by commissions that result from recruiting others to join the scheme, just like BurnLounge did.

The similarities between BurnLounge and Five Star Auto Club are even more striking.[19] Like BurnLounge, Five Star Auto Club offered participants the

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[19] Contrary to defendants' claim, Five Star Auto Club involved the sale of memberships and was not an inventory-loading case. BurnLounge Br. 46-48; Five Star Auto Club, 97 F. Supp. 2d at 509-12.

chance to enter at one of three levels, with the most expensive level – "member-consultant" – offering the greatest opportunity to earn commissions and rewards from the sale of memberships to others. Five Star Auto Club, Inc., 97 F. Supp. 2d at 509-10. Like BurnLounge, Five Star Auto Club included some ancillary services with the memberships – including roadside towing, specially-priced insurance, and even a dental plan – but participants were interested in these and the court found they were included "solely to stave off regulation." Id. at 509. Dr. Vander Nat also testified as an expert in Five Star Auto Club, and determined there, as here, that participants predominantly joined at the highest level. Id. at 517. That court found that this purchase pattern demonstrated the motivations of the customers involved: "For those participants who joined as consultants, the only lure offered was the opportunity to earn commissions by recruiting others. The fact that virtually no one joined Five Star as just a member [a level that did not offer commissions] indicates that the services purportedly available to members . . . were neither the focus nor the appeal of the Five Star program." Id. at 530. Finally, as in the present case, participants were virtually guaranteed not to recoup their payments. Dr. Vander Nat calculated that 95% of all participants lost money on the scheme. Id. at 518, 532.

The pyramid scheme found illegal in In re Holiday Magic, Inc., 84 F.T.C.

748, 1974 WL 175319 (1974), is also similar to BurnLounge. Defendants claim that the FTC found Holiday Magic to be an illegal pyramid because it involved "exorbitant" inventory purchases with no regard for retail sales. BurnLounge Br. 48. But this mistakes the Commission's reasoning: "While some attention was certainly paid by the organization to the retail sales of its products, it is clear from the record that the major emphasis in promoting the program, and the major attraction for many participants, was the prospect of the profits to be made through recruitment of others." 84 F.T.C. at 1035, 1974 WL 175319, *206. This description could be applied to BurnLounge without alteration.

Conversely, Amway is clearly distinguishable. The FTC found Amway not to be a pyramid scheme because of its policies to deter inventory-loading and to promote retail sales. 93 F.T.C. at 716-17, 1979 WL 198944, *69-*70. But BurnLounge had no such policies. Instead, the company paid the highest bonuses for the sales of packages, and only rewarded sales of music – its ostensible product – through the Concentric Rewards portion of the compensation plan, which was so convoluted that even BurnLounge did not try to illustrate fully how it worked. Vander Nat, 8 RT 93-94 [11 SER 991-92]. Because BurnLounge did not encourage outside retail sales of music as Amway did, BurnLounge is

[20] Defendants argue that, like Amway, BurnLounge paid commissions to its Mogul-distributors for internal sales to recruits. They pull isolated references from an FTC staff opinion and from Whole Living

of these items to ultimate users and BurnLounge could not be a pyramid scheme under the definition in *Koscot*. BurnLounge Br. 39-42. This claim is erroneous both in law and in fact.

For one, defendants are simply incorrect in claiming that sales of packages from one Mogul to another are sales to "ultimate users." Although they purport to rely on a "*Koscot*/*Omnitrition* test," BurnLounge Br. 39 n.20, this Court in *Omnitrition* definitively ruled that "ultimate users" are the external customers for the business's ostensible product, not the business's own internal sales force. 79 F.3d at 783. In that case, Omnitrition argued that it could not be found a pyramid because it employed the same anti-loading policies as in *Amway*. *Amway*, 79 F.3d at 782-83. But Omnitrition allowed these policies to be satisfied by sales downline to internal distributors or for the distributor's own personal use. *Id.* at 783. This Court found this insufficient to promote the retail sales necessary to avoid pyramiding. As this Court said, "*Koscot* is to have any teeth, such a [non-retail] sale cannot satisfy the requirement that sales be to 'ultimate users' of a product." *Omnitrition*

Omnitrition, internal sales to other Moguls cannot be sales to ultimate users consistent with Koscot. And if such sales are correctly ignored, no more is needed to uphold the district court's conclusion that Burnlounge was an unlawful pyramid scheme.

As noted above, the district court did not treat this consideration as dispositive,[21] although it recognized the importance of the fact that the vast majority of Burnlounge's sales and revenues came from such transactions, especially the sale of premium "packages" to Moguls. The court's analysis turned on two key findings it made, based on its e

[21] This Court may, however, affirm on this ground alone, which is legally sufficient, was argued below by the Commission, and is well supported by the record. See Cigna Prop. & Cas. Ins. Co. v. Polaris Pictures Corp., 159 F.3d 412, 418-19 (9th Cir. 1998).

them, describing them variously as “not credible and unsupported by the evidence[,]” “inapt and without convincing supporting evidence[,]” “defective[,]” and “mak[ing] no sense. . . .” Decision, 7-9 [5 ER 0050-52].

Second, as discussed above, the district court carefully analyzed the patterns of consumers’ purchases of the various packages, in relationship to the compensation plan that made it quicker and easier for those consumers who purchased the expensive premium packages to qualify for bonuses, with minimal

Thus, the court below found that the vast majority of participants were making payments to Burnlounge – most notably in the form of the $100 or $400 premiums for the higher-level packages – in the hope of earning bonuses from the sale of such packages to downstream customers. Decision, 22-24 [5 ER 0065-67]. This is the very hallmark of a pyramid scheme. As this Court stated in Omnitrition, "Omnitrition cannot save itself simply by pointing to the fact that it makes some retail sales." 79 F.3d at 782. *See also Stull*

not appropriate for pyramid scheme analysis. BurnLounge Br. 50-51. Defendants also point to *Ger-Ro-Mar v. FTC* to claim that mathematical evidence is insufficient to establish a pyramid. *Id.*, 45-46. But in that case, the only mathematical evidence offered was a hypothetical projection of the number of participants, without any data reflecting actual effects. *Ger-Ro-Mar, Inc. v. FTC*, 518 F.2d 33, 37 (2d Cir. 1975). Here, the mathematical evidence included BurnLounge's own sales data, calculated on the basis of each customer's payments into and receipts from BurnLounge. Such evidence of the actual practices and effect of a pyramid is exactly what courts find necessary to establish its existence.[22] *Gold Unlimited*, 177 F.3d at 475, 481-82; *Omnitrition*, 79 F.3d at 783-84; *Whole Living*, 344 F. Supp. 2d at 745-46; *Amway*, 93 F.T.C. at 715-17, 1979 WL 198944, *68-*70.

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[22] Defendants claim that the FTC failed to account for those participants who opted to become Moguls but generated no sales or commissions, a group known as the "non-entrepreneurs." BurnLounge Br. 51; Vander Nat, 9 RT 35-36 [12 SER 117-18]. But, as Dr. Vander Nat testified, he did account for them by treating them exactly like other Moguls. Vander Nat, 9 RT 37-38 [12 SER 119-20]. Though defendants imply that the non-entrepreneurs had some alternative motivation, the court noted that BurnLounge offered no evidence to support this conclusion. Decision, 26 [5 ER 0069]. Instead, the court found it more likely that these individuals intended to participate in the business opportunity but found it too difficult. Decision, 11 n.19 [5 ER 0054].

Defendants also observe that, on average, an individual opted to be a Mogul for 6.8 months, but they do not explain why this has any relevance. BurnLounge Br. 51. Since Dr. Vander Nat calculated actual harm to each consumer based on their net receipts, the length of time each was a Mogul is irrelevant.

For all these reasons, the court correctly determined that BurnLounge was an illegal pyramid scheme.

II. The court properly allowed Dr. Vander Nat's expert testimony.

Defendants attempt to challenge the admission of Dr. Vander Nat's testimony, but their claims rest on nothing more than erroneous statements of the law and mischaracterizations of the record.

The admission of expert testimony is governed by Rule 702 of the Federal Rules of Evidence. This rule was amended in 2000 to reflect the Supreme Court's decisions in *Daubert* and in *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (1999). FED. R. EVID. 702 advisory committee's note. In *Daubert*, the Court established a "liberal" standard for expert opinion testimony, holding such testimony admissible if it is scientifically valid and will assist the trier of fact to understand or determine a fact in issue – in other words, if the testimony is reliable and relevant. *Daubert*

admit expert testimony. 526 U.S. at 151, 153 (citing Gen. Elec. Co. v. Joiner, 522 U.S. 136, 143 (1997)).

This "broad latitude" is particularly appropriate in a bench trial, where there is no risk that expert testimony would mislead or confuse a jury. See Shore v. County of Mohave, 644 F.2d 1320, 1322-23 (9th Cir. 1981) ("Since this was a bench trial, there was little danger under the circumstances that the court would have been unduly impressed by the expert's testimony or opinion."); Green Mountain Chrysler Plymouth Dodge Jeep v. Crombie, 508 F. Supp. 2d 295, 312 (D. Vt. 2007).

For these reasons, the district court acted well within its discretion in admitting Dr. Vander Nat's expert testimony. The testimony was unquestionably relevant to facts in issue, including whether BurnLounge operated a pyramid and the amount of consumer harm. The testimony was also reliable. Dr. Vander Nat is an established expert in the field, with a doctorate in economics and advanced graduate study in mathematics. Vander Nat, 8 RT 34-35 [72 ER 1042-43]; Ex. 399 [36 SER]. He has provided expert opinions on behalf of the FTC and other government agencies in numerous cases, having analyzed at least 15 different companies, and having testified as an expert at trial involving five of those, including some cited favorably by defendants. Ex. 399 [36 SER]; BurnLounge Br.

47-48 (citing *Five Star Auto Club*). He is also the co-author of the leading academic article on the analysis of pyramid schemes. Ex. 1130 [24 ER].

As this Court and others have recognized, the preferred method to challenge expert testimony is not exclusion, but cross-examination and opposing evidence. *See De Saracho*, 206 F.3d at 880; *Green Mountain Chrysler Plymouth Dodge Jeep*, 508 F. Supp. 2d at 312 (citing *Daubert*, 509 U.S. at 596). Defendants' counsel did just that, cross-examining Dr. Vander Nat over two trial days. Defendants also introduced evidence from two separate experts in an attempt to rebut Dr. Vander Nat's findings. As the district court relied heavily on Dr. Vander Nat, refused to credit Nolte, and never mentioned Luce, it is plain that they failed.

Defendants now seek to exclude Dr. Vander Nat's testimony, based largely on distortions of what he said. Defendants primarily claim that Dr. Vander Nat used a four-factor test that is not published and would not necessarily lead to results consistent with *Koscot*'s definition of a pyramid. Burn Lounge Br. 29-30; Taylor Br. 17-19, 20.

But this was not Dr. Vander Nat's testimony. Instead, he articulated a definition of a pyramid that is entirely consistent with both *Koscot* and *Omnitrition*. *See Koscot*, 86 F.T.C. at 1180-81, 1975 WL 173318, *59-*60; *Omnitrition*, 79 F.3d at 781-82. He stated:

A pyramid scheme is an organization in which the participants obtain their monetary rewards primarily through enrolling new people into the program rather than selling goods and services to the public. And because the funding of the rewards hinges critically on the ongoing enrollment of new participants, a situation is created in which, in fact,

Koscot test."); Vander Nat, 11 RT 36-41 [14 SER 129-34]; Ex. 1130 at 141 [24 ER 0532] (citing Koscot and Omnitrition in his published article). They are also consistent with those cases holding that pyramid schemes are identified by their practical effects. See, e.g., Gold Unlimited, Inc., 177 F.3d at 475; Omnitrition, 79 F.3d at 783-84.

Defendants err in contending that Dr. Vander Nat admitted his test would lead to inconsistent results. BurnLounge Br. 30; Taylor Br. 17. As he stated, applying these factors in evaluating a possible pyramid scheme could lead to different results where the specific facts in a case are different. Vander Nat, 9 RT 63-64 [12 SER 125-26].

Defendants' criticism of Dr. Vander Nat's testimony that there are similarities between legal MLMs and illegal pyramids is entirely misplaced. BurnLounge Br. 30. The very purpose of his expert analysis and testimony is to assist courts in distinguishing between legitimate MLMs and the many unlawful pyramid schemes that – like defendants' – are disguised to resemble legitimate MLMs.[23] Nor is there any merit to the quite that Dr. Vander Nat's analysis here differed from the mathematical test described in his earlier article. BurnLounge

[23] Accordingly, it is unremarkable that Dr. Vander Nat has never studied a legal MLM in detail, because, as he pointed out, he only analyzes those cases brought to him in his capacity as a government expert on pyramid schemes. Vander Nat, 8 RT 35-41 [11 SER 66-72]; 9 RT 51-52 [12 SER 121-22].

[24] At trial, defendants sought to admit two surveys by the Direct Selling

considering its sales data is likewise of no moment. He reached his initial conclusions after reviewing the company's compensation plans and promotional materials. Vander Nat Decl., 1 [90 ER 1241]. Once he received the data, it not only confirmed his initial conclusions, but showed that they were too conservative. Compare Vander Nat Decl., 26-27 [90 ER 1266-67] with Vander Nat, 9 RT 11-12 [12 SER 103-04].

Defendants' challenges to Dr. Vander Nat's testimony thus rest on misunderstandings of the law and mischaracterizations of his testimony. Dr. Vander Nat's testimony was reliable and relevant, and thus properly admitted under Fed. R. Evid. 702.

III. The court properly determined that the remedies should include injunctive relief and equitable monetary relief in the form of disgorgement.

Section 13(b) of the FTC Act, 15 U.S.C. § 53(b), provides that a court may grant a permanent injunction against violations of "any provision of law enforced by the Federal Trade Commission." 15 U.S.C. § 53(b); Pantron I Corp., 33 F.3d at 1102. Once the equitable power of a court has been invoked, the court can impose "any ancillary relief necessary to accomplish complete justice," including ordering disgorgement or restitution to fully compensate injured consumers. Pantron I Corp., 33 F.3d at 1102; FTC v. H. N. Singer, Inc., 668 F.2d 1107, 1111-13 (9th Cir.

1982). The district court correctly identified and applied these principles.

A. The court's injunctive relief was proper.

Taylor objects to the court's definition of "Prohibited Marketing Scheme" in the Final Amended Order and Judgment. Taylor Br. 13. He claims that this definition, which excludes internal sales from "sales to ultimate users," will have a "potentially significant adverse consequence" if it is used to classify as a pyramid every activity where one participant sells to another. *Id.*

But this definition is already embedded in the definition of a pyramid scheme. *Omnitrition*, 79 F.3d at 783. And the district court's order, when read in context, clearly ties the definition of sale to rewards for recruiting consistent with governing law; it is not a blanket prohibition on paying rewards for internal sales. Dkt. 474 at 5 [3 ER 0028]. More importantly, this definition was formulated by the court under its broad authority to fashion relief after finding that BurnLounge had violated Section 5. As such, it is well within the court's remedial discretion in this case, regardless of the proper treatment of "internal" sales in other contexts. Indeed, this order is consistent with orders entered in other pyramid scheme cases, including *Koscot* itself. *See Koscot*, 86 F.T.C. at 1186, ¶ 2, 1975 WL 173318, *63. For these reasons, Taylor's argument about potential consequences is without

basis.[25]

B. The court's determination of equitable monetary relief was proper.

1. The FTC's authority to obtain this relief is well-established.

Defendants challenge the FTC's authority to obtain equitable monetary relief with arguments dating back to *Singer* and the legislative history of Section 13(b). *Burn* Lounge Br. 54-59. But it is now firmly established, in this Circuit and the majority of others, that the equitable monetary relief ordered here is authorized under Section 13(b). *See, e.g.*, *Shire*, 917 F.3d at 1093-97; *Stefanchik*, 559 F.3d at 931-32;

[25] Amicus curiae DSA raises a similar concern in its brief, DSA Br. 13-14, 20-23, and it is likewise without basis.

order to obtain equitable relief, there is no support – either from this Court's precedents or those of any other court – for this proposition. BurnLounge Br. 58-59. Indeed, the Second Circuit has rejected this argument, and the application of Great-West to violations of the FTC Act like this one, in Bronson Partners, 654 F.3d at 371-74. That court recognized that "[B]ronson can point to no case in which a public agency seeking to obtain equitable monetary relief has been required to satisfy the tracing rules." Id. at 374.

2. The court's calculation was proper.

Although defendants challenge the amount and calculation of the award, BurnLounge Br. 61-64, a district court's decision to award equitable monetary or injunctive relief is a matter of discretion. Stefanchik, 559 F.3d at 931. Here, the court did not abuse its discretion by electing to make its own calculation. In fact, as the court explained, it was trying to give defendants "a generous benefit of the doubt" – a fact which undercuts many of defendants' challenges. Decision, 27 [5 ER 0070].

For one, defendants' claims fail as a matter of law. It is widely accepted that consumers should receive "the full amount lost . . ." Stefanchik, 559 F.3d at 931; Febre, 128 F.3d at 536. This Court has also held that relief need not account for inherent value in a product sold deceptively because "[t]he fraud in the selling, not

the value of the thing sold, is what entitles consumers" to relief. FTC v. Figgie Int'l, Inc., 994 F.2d 595, 606 (9th Cir. 1993). Here, 94% of consumers lost money on what was supposed to be a money-making proposition. Under Stefanchik and Febre, defendants should therefore disgorge the full amounts received from these consumers, and the court would have been correct not to offset these amounts for any value of the included items.

These arguments also fail in fact. As discussed above, the court decisively rejected defendants' proposed valuation of the package merchandise. Decision, 8-10 [5 ER 0051-53]. Accordingly, it was not error for the court to decline to offset any award by this nonexistent value. Nonetheless, the court bent over backwards to account for the perceived value of the items in the packages by offsetting the total populations of Moguls participating at various price points to reflect those who apparently found some value in the package. Decision, 26-27 [5 ER 0069-70]. Thus, it is simply incorrect for defendants to complain that the court did not account for the value of the items, even though by law and its own factual findings the court was not required to do so.

Nonetheless, defendants also argue that the relief should be calculated from the minimal cost required to qualify as a Mogul: the $29.95 for the Basic package. BurnLounge Br. 63-64. The court flatly rejected this argument, finding as a matter

of fact "clearly that was not the case." Participants paid the additional $100 or $400 for the ability to more quickly earn higher Mogul Team Bonuses for inducing

[26] The district court properly rejected this argument when defendants asserted it in their Rule 59 motion, finding that they "could have raised and focused on [it] during the trial but did not." Dkt. 528 at 4 [1 ER 0004]. The court also noted that defendants' claim was questionable because Dr. Vander Nat saw "no substantive differences" between the earlier versions and those presented at trial. Id. at 5 [1 ER 0005]; Vander Nat, 3d Supp. Decl., Dkt. 480-2, Att. A, at 2-3 [40 SER 220-21].

[27] Ex. 330 [45 ER] shows that BurnLounge paid out $17,316,980 in

determination that is well within the court's discretion.

3. Defendants' liability on Counts II and III supports the court's equitable monetary relief.

Defendants argue that the monetary relief in this case hinges on the pyramid scheme count and "may not be saved by any alternative ground." BurnLounge Br. 61; Taylor Br. 21. But defendants do not dispute that they are liable under Counts II and III. Even if BurnLounge were an otherwise lawful business and not a pyramid, the FTC would still be entitled to equitable monetary relief for these deceptive income claims. *Stefanchik*, 559 F.3d at 926-28, 931-32 (affirming equitable monetary relief for deceptive income claims); *accord FTC v. Kitco of Nevada, Inc.*, 612 F. Supp. 1282, 1292, 1295-96 (D. Minn. 1985) (citing *Goodman v. FTC*, 244 F.2d 584, 596, 599 (9th Cir. 1957)). Accordingly, this Court could properly affirm the judgment below on the basis of defendants' unappealed liability on Counts II and III, even if it were to reject all of our arguments for affirmance of the lower court's ruling on Count I.

The profit potential of a business opportunity is important to consumers, and a misrepresentation is a material violation of Section 5. *Five Star Auto Club*, 97 F. Supp. 2d at 529 (citing *FTC v. Minuteman Press*, 53 F. Supp. 2d 248, 258 (E.D.N.Y. 1998)); *Kitco*, 612 F. Supp. at 1292. The court below agreed that the income claims were material, stating "[w]here a person markets what is in essence

a pyramid scheme, he/she must at a minimum advise potential investors of the unlikelihood of any substantial returns." Decision, 25 [5 ER 0068]. This is logical, because if defendants had not misrepresented the earnings potential, few, if any, consumers would have elected to participate.

Defendants challenge the relief for the false claims by claiming the FTC did not prove that the claims were widely disseminated or that consumers relied on them. BurnLounge Br. 62 n.35; Taylor Br. 21 n.6. To prove reliance in a 13(b) action, the FTC must show the misrepresentations were the kind usually relied upon by reasonable and prudent persons, they were widely disseminated, and injured consumers actually purchased the products. See, e.g., Rare Coin & Bullion Corp., 931 F.2d at 1316 (citing FTC v. Amy Travel Serv., Inc., 875 F.2d 564, 573 (7th Cir. 1989)). As material information, income claims are the types of statements usually relied upon by reasonable consumers. The evidence of nationwide dissemination was plain. And BurnLounge's own sales data definitively confirmed consumer purchases. Accordingly, the FTC sufficiently established reliance.

Nor must the FTC prove actual reliance. "Requiring proof of subjective reliance by each individual consumer would thwart effective prosecutions of large consumer redress actions and frustrate the statutory goals of [Section 13(b)]." Five

the court found, he had the highest possible degree of participation in the company's affairs: he originated the concept, he served as one of the primary investors and shareholders, he developed the compensation plan, and he controlled

[28] Though defendants claim otherwise, BurnLounge Br. 60-61, Arnold's participation and knowledge were far more encompassing than the defendant's in Publishing Clearing House

expressed concerns that BurnLounge was a pyramid. Ex. 255 [29 SER]. The private placement memorandum he approved identified pyramid claims as a potential risk. Arnold, 6 RT 143-45 [9 SER 055-57]; Ex. 242 at 48 [26 SER 187]. He was interviewed for, read, and used validation for BurnLounge a Billboard Magazine article that commented on th

[29] The evidence of Arnold's expenses rests partially on Ex. 55, an e-mail from his lawyer summarizing his financial position that was not admitted as hearsay. Ex. 55 was used to refresh his recollection, however, and Arnold's own testimony confirmed the amounts. See

that the FTC had not proven how many consumers relied on DeBoer's false statements to their detriment. Id. Third, the court elected to credit DeBoer for his expenses and sales of music outside of the pyramid, but found that the FTC had not offered evidence of the amount of these expenses. Decision, 30 [5 ER 0073]. Each of these reasons represents an error of law, and therefore is an abuse of the court's discretion. See, e.g., Perry, 667 F.3d at 1084.

The district court erred in reasoning that DeBoer should get credit for his expenses and music sales because he was only a participant. Participation and knowledge are the recognized legal bases for an individual to be found liable and subject to equitable monetary relief. Cyberspace.com, 453 F.3d at 1202; Amy Travel Serv., Inc., 875 F.2d at 573. The evidence of DeBoer's participation was mani4 TDhovenbTc 0Rifed oabutshis

presentations. DeBoer, 6 RT 59 [8 SER 043]. DeBoer also knew that his own statements were misleading. He admitted at trial that his standard pitch – about his "best friends" and their successes – was not true. Decision, at 18-19 [5 ER 0061-62]; DeBoer, 6 RT 53-55 [8 SER 040-42].

Moreover, "it is well established that defendants in a disgorgement action are 'not entitled to deduct costs associated with committing their illegal acts.'" Bronson Partners, 654 F.3d at 375; accord FTC v. Washington Data Resources, 704 F.3d 1323, 1327 (11th Cir. 2013). This Court follows this principle, finding that disgorgement is measured by the full amount lost by consumers. See Stefanchik, 559 F.3d at 931-32 (citing Febre, 128 F.3d at 536).

For the same reason, the court erred in giving DeBoer credit for music sales made outside of the pyramid. As these sales flowed from the illegal pyramid activity, proceeds from them should be disgorged as well. See, e.g., SEC v. JT Wallenbrock & Assocs., 440 F.3d 1109, 1113-14 (9th Cir. 2006) ("[T]he amount of disgorgement should include 'all gains flowing from the illegal activities.'").

Even if DeBoer's expenses were relevant, the district court erred in concluding that it was the FTC's burden to establish these expenses. See Decision, 30 [5 ER 0073]. Once the FTC proved that he earned $908,293.69, the burden of proof should have shifted to DeBoer to show this was inaccurate. See Bronson

Partners, 654 F.3d at 368; Febre, 128 F.3d at 535. Since DeBoer introduced no evidence of his expenses, he is entitled to no offset. Stefanchik

Taylor Br. 13-15, 21-22. As discussed above, the court did err, but not in Taylor's favor: it was incorrect to offset DeBoer's award for expenses and music sales.

Taylor cites various securities sources for the principle that any disgorgement should be calculated on the basis of his profit, or his receipts minus his expenses. Taylor Br. 13-15. But courts in SEC cases involving disgorgement equate "profits" and "proceeds," or total receipts, and do not allow for the deduction of expenses. *See SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1096 (9th Cir. 2010) (finding the SEC's calculation of the total proceeds received by defendants was nonetheless a reasonable approximation of profits); accord *SEC v. Levine*, 462 Fed. Appx. 717, 719 (9th Cir. 2011).

In a similar case involving a securities Ponzi scheme, this Court rejected an offset for defendants' expenses, finding "it would be unjust to permit the defendants to offset against the investor dollars they received the expenses of running the very business they created to defraud those investors into giving the defendants the money in the first place." *JT Wallenbrock & Assocs.*, 440 F.3d at 1114 (citing *SEC v. TLC Invs. & Trade Co.*

million in the scheme. Id. at 1113, 1117. For the same reasons, this Court should affirm the award against Taylor.

CONCLUSION

For all of the foregoing reasons, the judgment of the district court with respect to defendants BurnLounge, Arnold, and Taylor should be affirmed. The judgment of the district court with respect to defendant DeBoer should be reversed and he should be ordered to disgorge $98,293.69 – the full amount of his receipts from the illegal scheme.

Respectfully submitted,

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April 1, 2013

STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, I certify that the following are related cases:

Case No. 12-55926
Federal Trade Commission, plaintiff-appellee
v.
BurnLounge, Inc., defendant-appellant
Juan Alexander Arnold, defendant-appellant
John Taylor, defendant
Robert DeBoer, defendant

Case No. 12-56197
Federal Trade Commission, plaintiff-appellee
v.
BurnLounge, Inc., defendant
Juan Alexander Arnold, defendant
John Taylor, defendant-appellant
Robert DeBoer, defendant

Case No. 12-56228
Federal Trade Commission, plaintiff-appellant
v.
BurnLounge, Inc., defendant
Juan Alexander Arnold, defendant
John Taylor, defendant
Robert DeBoer, defendant-appellee

s/ Burke W. Kappler
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April 1, 2013

9th Circuit Case Number(s)

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