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:
CHRIS M. COUILLOU
DAMA J. BROWN
Federal Trade Commission
Atlanta, GA

DAVID C. SHONKA
Acting General Counsel

JOHN F. DALY
Deputy General Counsel for
Litigation

BURKE W. KAPPLER
Attorney
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
Washington, DC 20580
(202) 326-2043

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JURISDICTION

The Federal Trade Commission ("Commission" or "FTC") initiated an action in the United States District Court for the Central District of California seeking relief under Section 13(b) of the Federal Trade Commission Act ("FTC Act"), 15 U.S.C. § 53(b), for deceptive acts and practices that violated Section 5(a) of the FTC Act, 15 U.S.C. § 45(a). The district court had jurisdiction under 28 U.S.C. §§ 1331, 1337(a), and 1345, and 15 U.S.C. §§ 45(a) and 53(b).

The district court entered a final judgment on all counts of the complaint on July 25, 2011, and an amended final judgment on March 1, 2012. Defendants BurnLounge, Inc. ("BurnLounge") and Juan Alexander Arnold filed a timely motion to alter or amend judgment pursuant to Fed. R. Civ. P. 59, which the district court denied on May 3, 2012.

Pursuant to Fed. R. App. P. 4(a)(1)(B), defendants BurnLounge and Arnold timely filed notices of appeal on May 17, 2012, and defendant John Taylor timely filed a notice of appeal on June 27, 2012.[1] The Commission timely filed a cross-appeal notice on June 29, 2012, pursuant to Fed. R. App. P. 4(a)(3). This court has jurisdiction pursuant to 28 U.S.C. § 1291.

[1] Defendant Robert DeBoer did not appeal.

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.

6. Individual liability: Taylor: Whether the district court abused its discretion in finding John Taylor individually liable where the evidence showed he was directly and centrally involved in BurnLounge.

STATEMENT OF THE CASE[2]

A. Nature of the case, the course of proceedings, and the disposition below.

These cross-appeals arise from an action by the FTC, pursuant to Sections 5 and 13(b) of the FTC Act, 15 U.S.C. §§ 45 and 53(b), seeking preliminary and permanent injunctive relief, and equitable monetary relief, against defendants BurnLounge, Arnold, Taylor, and DeBoer for promoting an illegal pyramid scheme.[3]

On June 6, 2007, the FTC filed its complaint, alleging three violations of Section 5 of the FTC Act, 15 U.S.C. § 45(a): (1) defendants promoted an illegal pyramid scheme; (2) defendants misrepresented that participants were likely to

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[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 refer 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 a separate stipulated order in June 2008. Dkt. 248.

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 minor changes. Dkt. 473 [39 SER], 474 [3 ER]. The amended order provided that the amounts received from Arnold would contribute to a redress fund for consumers, and that, consistent with the Decision, Arnold would be responsible for a minimum of $1,664,506.45. *See* Dkt. 474 at 10 [3 ER 0033] (citing Decision, 28 n.48 [5 ER 0071]).

On March 29, 2012, defendants BurnLounge 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 occurs where participants pay money for the right to sell a product and for the right to receive rewards for recruiting others that are unrelated to the retail product sales. *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1180, 1975 WL 173318, *59 (1975), *aff'd mem. sub nom., Turner v. FTC*, 580 F.2d 701 (D.C. Cir. 1978). The right to receive rewards for recruiting is inherently deceptive because it promises that participants can recoup their investment by persuading others to invest, a practice described as "nothing more than an elaborate chain letter . . . ." *Koscot*, 86 F.T.C. at 1180-81, 1975 WL 173318, *59-*60.

BurnLounge and its representatives told consumers that BurnLounge offered the opportunity to run an online music store. In reality, BurnLounge's business was predominantly a pyramid scheme that depended on the recruitment of

additional salespeople through the sales 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 of 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. 1, 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].

become a qualified Mogul by: (1) purchasing one of the three types of packages; (2) recruiting two participants by selling them a premium, *i.e.*, Exclusive or VIP, package; (3) paying monthly Mogul dues of $6.95; and (4) selling two albums per month. Ex. 10 at 3, 7-8 [55 ER 0687, 0691-92]; Ex. 8 at 5-6 [56 ER 0699-0700].

a. Mogul Team Bonuses

The Mogul Team Bonus is the most important for the pyramid analysis because it paid cash to Moguls for recruiting, and it constitutes the greater part of the bonuses paid by BurnLounge. Only Moguls could earn the Mogul Team Bonus. Ex. 10 at 7 [55 ER 0691].

The requirement that a Mogul sell packages to two other participants established two sales teams – an A-side and a B-side – beneath that Mogul. Ex. 10 at 9 [55 ER 0693]; Ex. 8 at 30 [56 ER 0724]; Ex. 43 at 1169-70 [21 SER 171-72]; Ex. 417 [44 ER]. In turn, each of these recruits could themselves become eligible for the Mogul Team Bonus by meeting the requirements above.

Each package sale by a Mogul or within her organization earned points for that Mogul.[7] Sale of a VIP package earned 400 points, sale of an Exclusive package earned 100 points, but sales of a Basic package earned 0 points. Ex. 10 at

[7] These points are known as "Mogul Points" and are different from the BurnRewards points participants could earn through sales of music or merchandise. *See*, *e.g.*, Ex. 10 at 8 [55 ER 0692].

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 "cycle 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).

This bonus structure encouraged Moguls to buy and sell the most expensive VIP packages. Moguls who bought the VIP package were automatically eligible for the highest bonus ($50) with only minimal album sales required.[10] And Moguls who sold VIP packages would receive higher Mogul Team points and thus would earn bonuses more quickly.[11] *See, e.g.*, Ex. 43 at 1169-70 [21 SER 171-72]. Thus, ironically for a company that advertised itself as being in the music business, the highest bonuses were paid to the individuals who were required to sell the least amount of music.

The Mogul Team Bonus was the most lucrative of the bonuses, and BurnLounge paid out over $11 million in Mogul Team Bonuses in 2006 and 2007. Ex. 258 at D0013677 [30 SER 196] ($8,480,975 in FY 2006); Ex. 259 at D0013680 [31 SER 199] ($2,660,850 in FY 2007); Vander Nat, 11 RT 72-74 [14 SER 135-37].

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[10] Indeed, retailers were advised to have their spouses buy albums as a painless way of meeting these requirements. Taylor, 4 RT 149-50 [6 SER 024-25]; Keranen, 14 RT 12-14 [16 SER 141-43].

[11] Another incentive to sell VIP packages came from the Product Package Bonus, a different program that simply paid a one-time bonus for a direct sale of a package. A Mogul earned $50 for selling a VIP package, $25 for an Exclusive package, and $10 for a Basic package. Ex. 10 at 6-7 [55 ER 0690-91]; Ex. 8 at 30 [56 ER 0724].

b. Concentric Retail Rewards

The Concentric Retail rewards were the only compensation ostensibly related to music sales. Here, participants – retailers or Moguls – could earn BurnRewards points based on music or merchandise sales through their own BurnLounge store. The rewards were based on a calculation of BurnLounge's gross margin on that item. For each song sold, a Mogul could earn 2 or 5 cents, while a non-Mogul retailer could earn the fractional equivalent amount in BurnRewards points. For each album, a participant could earn 50 cents, or 20% of the gross margin on the album. Ex. 10 at 4-5 [55 ER 0688-89]; Ex. 8 at 29 [56 ER 0723]. The Concentric Retail program also paid rewards for the first $30 of any package sold, and for the $8 in monthly dues for the Exclusive and VIP packages. Ex. 10 at 6 [55 ER 0690] ("Product sales" definition); Ex. 8 at 28 [56 ER 0722] (same).

Like the Mogul Team Bonus, Concentric Retail offered another opportunity to earn rewards from sales by recruits. Unlike the Mogul Team Bonus, however, Concentric Retail operated in "rings." Ex. 10 at 5-6 [55 ER 0689-90]; Ex. 8 at 28-29 [56 ER 0722-23]. To earn rewards from these rings, a retailer or Mogul had to maintain her own monthly album sales, generate album sales through her sales team, and sell additional packages (or "stores"). Ex. 10 at 5-6 [55 ER 0689-90].

As structured, the Concentric Retail program was opaque, onerous, and not nearly as lucrative as the Mogul Team Bonus. *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 [90 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].

of music. Vander Nat, 8 RT 126-27 [11 SER 096-97]; Vander Nat Decl., 46 [90 ER 1286].

4. BurnLounge's Promotion and Marketing

BurnLounge promoted its offerings through a variety of means, but relied heavily on sales meetings and conference calls. All of the individual defendants participated in these presentations and, in doing so, they made false claims about the potential income from BurnLounge. Decision, 17-19 [5 ER 0060-62]. Defendants made these claims despite the fact that doing so contravened BurnLounge's policies and procedures. Ex. 8 at 13 [56 ER 0707]. And defendants never disclosed that these claims were false, or that, in truth, most Moguls would not earn any profit at all.

In this appeal, defendants concede that these claims were false, and have raised no challenge to the district court's findings. *See* Appellants' Opening Brief by BurnLounge, Inc. and Juan Alexander Arnold ("BurnLounge Br."), 12-13, 25; Appellant's Opening Brief by John Taylor ("Taylor Br."), 8.

BurnLounge's marketing was disseminated nationally. The FTC introduced transcripts from meetings in six different locations, and from conference calls or pre-recorded calls available online. Ex. 1163 [19 ER]. In addition, all of the individual defendants testified that they regularly traveled and presented at

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., 13-18 [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 BurnRewards points 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].

non-Moguls – those customers who purchased music or packages, but did not opt to become a Mogul. Ex. 422 [42 ER]. Of the 57,997 non-Moguls, only 3.4% (or 1,980) even purchased a package, and of those, 65.5% (or 1,297) purchased the cheapest Basic package.[14] *Id.* In sum, 95.8% of Moguls – those individuals who wanted cash for their sales – purchased one of the premium packages that offered bonuses with only minimal music sales required, while 96.6% of non-Moguls purchased no package at all. *Id.*

As a further result, packages sales drove 92.6% of BurnLounge's revenue in 2006, its one full year of operation, while music sales during the same year only amounted to 4.9% of revenue. Ex. 242 at 52 [26 SER 188]. During BurnLounge's entire operation, the company earned $19,686,327 from sales of packages to Moguls, compared to $1,503,240 in music sales. Ex. 1051 [40 ER].

Through its expert, Dr. Peter Vander Nat, the FTC showed these results and why they demonstrated BurnLounge was a pyramid. Dr. Vander Nat's analysis looked at four types of evidence: (1) the terms and conditions for earning compensation; (2) the variety of materials for marketing the program; (3) an optimal scenario in which every participant in the scenario attempts to achieve the

[14] A non-Mogul who purchased a package could earn BurnRewards points that he could exchange for music or merchandise, but could not convert these points to cash without becoming a Mogul. Ex. 10, at 4 [55 ER 0688].

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 [11 SER 078-87]; Vander Nat Decl.,

[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 – or *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 album sales revenue. Vander Nat, 8 RT 71-72 [11 SER 089-90]; Ex. 366 [33 SER]. But, at the same time, the Moguls would receive rewards and bonuses in the amount of $705,400, a 17-to-1 ratio of bonuses to revenue that showed that BurnLounge could not sustainably fund rewards through album sales. Vander Nat, 8 RT 71-72 [11 SER 89-90]; Vander Nat Decl.,

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 $21.4 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 abandon 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 retailers. Defendants provided testimony from two expert witnesses: David Nolte, who addressed the valuation of the items included with the various packages, and Alan Luce, who testified on multilevel marketing companies. Dkts. 373 [68 ER], 375 [64 ER], 377 [62 ER], 381 [59 ER].

Nolte, a professional appraiser and accountant, testified that the items included in the packages had value that exceeded the prices of the packages. Nolte, 14 RT 177-79 [18 SER]. Nolte reached this conclusion by comparing each

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 watched 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 (*i.e.* 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, and data showed that all of the packages were tools for recruitment, and the more lucrative the rewards, the greater the incentive to recruit. Decision, 22-23 [5 ER

0065-66].

The court accepted Dr. Vander Nat's analysis of the impact on consumers, finding that this emphasis on recruitment meant that, at a minimum, 87.5% of recruits would not recoup their investment, and in fact, 93.84% did not. Decision, 16-17 [5 ER 0059-60]. The court further found that while BurnLounge did generate some revenue from music sales – its ostensible product – these sales "could never (and in fact never did) fund any substantial portion of the rewards for the Mogul program." Decision, 17 [5 ER 0060].

The court squarely rejected defendants' argument that the items included with the packages had independent value, and thus that rewards from the sales of these packages were related to "sales to ultimate users." The court found "clearly that was not the case." Decision, 23 [5 ER 0066]. The court reviewed Nolte's valuations of the items in each package and found each valuation not credible and factually unsupported.[17] Decision, 6-10 [5 ER 0049-53]. Ultimately, the court rejected defendants' valuation evidence as not "even remotely persuasive." Decision, 8 [5 ER 0051].

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[17] The court also did not accept Nolte's alternative harm calculation and in fact plainly rejected his premises. *Compare* Nolte, 15 RT 20-23 [58 ER 0786-89] *with* Decision, 11 n.19, 26-27 [5 ER 0054, 0069-70]. With respect to defendants' other expert, the court never mentioned Luce and apparently did not credit his testimony at all.

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. 422 [42 ER]). Decision, 26 [5 ER 0069] (citing *FTC v. QT, Inc.*, 512 F.3d 858, 864 (7th Cir. 2008)). First, the court limited the population of consumers harmed, by excluding Moguls who made a profit. *Id.* Then, using the company's data and Dr. Vander Nat's analysis, the court determined that 10.8% of Moguls found enough value in the Basic package to buy it without the business opportunity, meaning that 89.2% of Moguls would not have bought it but for the business opportunity. Decision, 26-27 [5 ER 0069-70]. The court multiplied this 89.2% rate against the number of Moguls who bought the Basic package and its cost to calculate the consumer harm from the Basic package. *Id.* The court performed the

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 BurnLounge 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 also 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. *Id.* 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. Vander 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], 474 [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 provides that funds provided by Arnold as part of his joint and several liability for such redress are to be returned to him periodically, if not used for that purpose. Dkt. 473 at 2 [39 SER 217]; Dkt. 474 at 10 [3 ER 0033]. However, in keeping with its earlier merits ruling, the amended order makes clear that Arnold remains liable, in any event, for $1,664,506.45, representing disgorgement of his own income from the scheme. Dkt. 474 at 10 [3 ER 0033] (citing Decision, 28 n.48 [5 ER 0071]). Third, the court denied defendants' Motion to Alter or Amend Judgment under Fed. R. Civ. P. 59. Dkt. 477 [10 ER], 488 [2 ER].

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 "significantly deferential" and the trial court's findings should be accepted unless there is a "definite and firm conviction that a mistake has been committed." *Garvey*, 383 F.3d at 900 (citing *N. Queen Inc. v. Kinnear*, 298 F.3d 1090, 1095 (9th Cir. 2002)).

The trial court's conclusions of law following a bench trial are reviewed *de novo*. *Garvey*, 383 F.3d at 900 (citing *Brown v. United States*, 329 F.3d 664, 671 (9th Cir. 2003)).

2. Admission of expert testimony: A trial court's decision to admit expert testimony is reviewed for abuse of discretion; an appellate court should give "deference" to a trial court and may only reverse if the trial court's determination was "manifestly erroneous." *Gen. Elec. Co. v. Joiner*, 522 U.S. 136, 141-43 (1997); *De Saracho v. Custom Food Mach., Inc.*, 206 F.3d 874, 879 (9th Cir. 2000).

3. Equitable monetary and injunctive relief: The district court has broad authority under the FTC Act to "grant any ancillary relief necessary to accomplish

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 also 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 benefit of the doubt." This calculation was proper and consistent with the broad discretion afforded a district court in fashioning an equitable remedy.

The district court properly determined that both Arnold and Taylor played central roles in the BurnLounge scheme. Arnold was the creator, manager, and ultimate authority, with knowledge that BurnLounge was a pyramid, while Taylor was deeply involved as his "right-hand man." The court's disgorgement orders for both of these defendants properly reflect the evidence at trial.

But for DeBoer, the court erred in allowing him credit for his expenses and music sales and ordering him to disgorge only $150,000 of the $908,293.69 he earned from the scheme. This aspect of the court's decision and order should be reversed and DeBoer ordered to disgorge all of his receipts.

ARGUMENT

I. The court correctly determined that BurnLounge was an illegal pyramid scheme.

A. BurnLounge's structure and operations match precisely those of an illegal pyramid scheme as defined by this Court and others.

A pyramid scheme arises where individuals pay money to a business "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." *Koscot*, 86 F.T.C. at 1180, 1975 WL 173318, *59 (emphasis in original); *accord Omnitrition*, 79 F.3d at 781.

Pyramid schemes differ from legitimate multilevel marketing, or MLM, businesses because the primary purpose of pyramid schemes is to reward associates for the recruitment of others, while the purpose of legitimate MLMs is to encourage retail sales to end-consumers. *In re Amway Corp.*, 93 F.T.C. 618, 716-17, 1979 WL 198944, *70 (1979); *see also Stull v. YTB Int'l*, Civ. No. 10-600-GPM, 2011 WL 4476419, *5 (S.D. Ill. Sept. 26, 2011); *FTC v. Five Star Auto Club, Inc.*, 97 F. Supp. 2d 502, 531 (S.D.N.Y. 2000). As this Court has held, it is this "recruitment focus" that distinguishes a true pyramid scheme. *Omnitrition*, 79 F.3d at 781-82 (citing *Koscot*, 86 F.T.C. at 1181). Pyramid schemes typically require participating individuals to pay large sums of money for this recruitment

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 an 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*, 93 F.T.C. at 715-17, 1979 WL 198944, *68 -*70). In particular, a court should look at "the marketing strategy (*e.g.*, emphasis on recruitment versus sales)

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 rewards were "clearly" unrelated to sales to ultimate users because the included items had "no relevant value " to those who were instead buying the package for the opportunity to get cash through downline sales. Decision, 10, 23-24 [5 ER 0053, 0066-67].

As a result, BurnLounge created exactly the type of "recruitment focus" – with the same detrimental results – warned of in *Omnitrition* and the other pyramid

cases. For one, BurnLounge received over $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. 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. 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

money – purchased one of the premium packages that offered faster and larger bonuses, while over 96% of non-Moguls – those uninterested in the business – purchased no package at all. Decision, 16 [5 ER 0059] (citing Ex. 422 [42 ER]). These distinct patterns led the court to conclude, "[I]t was the business opportunity and not the products that drove sales of product packages." Decision, 17 [5 ER 0060] (citing Ex. 422 [42 ER]).[18] This was further confirmed when BurnLounge began to offer packages without the business opportunity and sales plummeted, confirming that participants only wanted the packages for the business opportunity. Decision, 16 [5 ER 0059] (citing Exs. 65 [22 SER], 67 [23 SER], 68 [24 SER]).

BurnLounge also mirrored *Koscot* and *Omnitrition* in another aspect: those at the bottom of the pyramid were unable to recoup their initial investment. Decision, 21-22 [5 ER 0064-65]. As the court found, nearly 94% of BurnLounge participants were unable to earn their money back, a figure even larger than that predicted by Dr. Vander Nat in his optimal scenario. Decision, 16-17 [5 ER 0059-60].

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[18] This is why defendants' claim about the FTC's burden to prove buyer motivation fails. BurnLounge Br. 50-51. For one, there is no such burden. *See Gold Unlimited*, 177 F.3d at 482 (finding government had "to do no more" than satisfy *Koscot*, while defendant had burden to prove that anti-pyramid policies were effective). But even if it existed, the FTC more than met it with this sales data and the testimony of four former Moguls. Ex. 422 [42 ER]; Baccus, 2 RT 13-15 [2 SER]; Becker, 2 RT 72-76 [3 SER]; Sharp, 2 RT 127, 149-50 [4 SER]; Bowers, 3 RT 8-9, 16-17 [5 SER].

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. *Id.*

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

[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 few participants were interested in these and the court found they were included "solely to stave off regulators." *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 levels. *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 091-92]. Because BurnLounge did not encourage outside retail sales of music as Amway did, BurnLounge is

distinguishable.[20]

For these reasons, the district court's conclusion that BurnLounge had demonstrated the "recruitment focus" and customer harm that are the hallmarks of an illegal pyramid scheme was entirely consistent with this Court's controlling decision in *Omnitrition*, the Commission's seminal ruling in *Koscot*, and the entire body of case law condemning pyramid schemes.

B. Defendants' argument misapplies governing law and is belied by the district court's findings of fact.

In response, defendants claim that the items included with the packages had independent value and that Moguls who purchased the packages did so for these items. Thus, they claim, any rewards paid for package sales were related to sales

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[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* to support their claim that commissions for internal sales for the purchaser's own use are not proof of a pyramid. BurnLounge Br. 44-45. To the extent this revisits defendants' claim that the FTC had to prove motivation, it fails for the reasons discussed above. But defendants also misread these authorities.

The FTC staff opinion concludes, "[A] multi-level compensation system funded primarily by payments made for the right to participate in the venture is an illegal pyramid scheme." Ex. 1049 at 1 [41 ER 0623]. BurnLounge's funding primarily flowed from the sales of packages required for recruiting. Ex. 1051 [40 ER]; Decision, 16 [5 ER 0059].

Similarly, *Whole Living* states, "The fact that there are some retail sales does not mitigate the unlawful nature of a pyramid scheme." *Whole Living*, 344 F. Supp. 2d at 745 (citing *Omnitrition*, 79 F.3d at 782-83). That BurnLounge made some retail sales, or that a few purchasers saw value in the items, does not alter the emphasis on recruitment found by the court. Decision, 22-23 [5 ER 0065-66].

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*. 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, "If *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*, 79 F.3d at 783 (emphasis added).

For this reason, though defendants strain to find references in the district court's opinion that suggest the items in the packages had value, these are of no moment. BurnLounge Br. 41; Taylor Br. 20. Applying this Court's teachings in

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 exhaustive review of the record. First, although the court below acknowledged that items included in the packages "had at least some minor value in and of themselves . . .," Decision, 10 [5 ER 0053], it soundly rejected defendants' attempt to portray the sale of packages to Moguls as constituting the sale of goods for fair value. The court rejected in its entirety the purported market-based valuation by defendants' expert Nolte, finding this evidence "neither overwhelming nor even remotely persuasive." Decision, 8 [5 ER 0051]. The court reviewed each of Nolte's comparisons and accepted none of

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[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 court below 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 sales of music. Decision, 16 [5 ER 0059]. Unsurprisingly, the vast majority of premium packages were purchased by consumers who also became Moguls – thus indicating that they joined the program in order to earn money – while only a handful of non-Mogul participants purchased those expensive packages. *Id.* As the court concluded, "[b]y and large, however, it was the business opportunity and not the products that drove the sales of packages." Decision, 17 [5 ER 0060]. In other words, while the court gave the defendants the "benefit of the doubt" by assuming that some small number of consumers valued the incidental items included in the packages – and reduced its assessment of total consumer harm accordingly – it correctly found, on the basis of all of this evidence, that for those Moguls interested in the business opportunity, the included items had "no relevant value." Decision, 10 & n.16, 23-24 [5 ER 0053, 0066-67].

Thus, the court below found that the great 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*, 2011 WL 4476419 at *5 (holding that the fact that an alleged pyramid scheme's product had some inherent value did not mean that it was not a pyramid); *Whole Living*, 344 F. Supp. 2d at 745 (citing *Omnitrition*, 79 F.3d at 782-83).

These holdings make sense from a policy perspective. If the test for a pyramid scheme hinged on whether the product or service was *entirely* devoid of value, then every pyramid scheme would do as defendants here have done – provide items of little marginal value to every participant in conjunction with the payment required to join the program, and then claim these are sales to ultimate users "to stave off regulators" and evade liability. *See Five Star Auto Club*, 97 F. Supp. 2d at 509.

Defendants point to cases about the limits of statistical evidence, but these cases involve the use of statistics to prove race and age discrimination and thus are

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*, 509 U.S. at 588, 592-93, 594-95. The Court offered a number of factors that a district court may consider in evaluating the proposed testimony, including testing, peer review and publication, and error rates, but ultimately "emphasize[d]" that the test for admissibility must be "a flexible one." *Daubert*, 509 U.S. at 593-94. In *Kumho*, the Court reaffirmed that these factors are "not definitive," and that a trial judge has "broad latitude to determine" whether to

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. BurnLounge 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, the vast majority of participants will not be in a position to recoup the rewards and, therefore, they fail to do so and they are harmed.

Vander Nat, 8 RT 43-44 [11 SER 073-74].

The "four factors" to which defendants repeatedly refer are the facts that Dr. Vander Nat examined to analyze BurnLounge according to this definition. Vander Nat, 8 RT 44 [72 ER 1045]. These factors were the terms and conditions of the compensation plan, an optimal scenario based on the assumption that all participants sought to maximize their benefits, the company's sales and financial data, and finally, the company's promotional materials. Vander Nat, 8 RT 44-45 [72 ER 1045-46]. In other words, Dr. Vander Nat looked at BurnLounge's plan, how it worked in theory, how it worked in practice, and what BurnLounge and its representatives said about it.

This definition and these factors are entirely consistently with *Koscot* and the other pyramid scheme cases described above, as Dr. Vander Nat recognized and stressed repeatedly. *See* Vander Nat, 9 RT 61-62 [70 ER 1030-31] (Dr. Vander Nat is familiar with *Koscot* and sees his factors as consistent); Vander Nat, 9 RT 63 [70 ER 1032] ("I see my four factors as a deepening analysis of the

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 critique 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 066-72]; 9 RT 51-52 [12 SER 121-22].

Br. 31; Taylor Br. 17. As Dr. Vander Nat testified, the test in the article applied to inventory cases, and this is not such a case. Vander Nat, 11 RT 53 [67 ER 956]. In fact, his article explicitly acknowledged that "Because pyramid schemes come in variations, our model will not serve as a template for all situations." Ex. 1130 at 140 [24 ER 0531].

Defendants distort Dr. Vander Nat's testimony in several other ways. BurnLounge Br. 27-28, 29-31. For instance, Dr. Vander Nat did not disregard consumer declarations, but rather considered them "one source" among many. Vander Nat, 10 RT 107-08 [69 ER 997-98]. He did not avoid survey evidence; instead, he testified that he was not aware of a single pyramid scheme case in which a consumer survey was done and that such evidence was not necessarily even relevant.[24] Vander Nat, 10 RT 112-14 [69 ER 1002-04]. The fact that Dr. Vander Nat formed an initial opinion that BurnLounge was a pyramid before

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[24] At trial, defendants sought to admit two surveys by the Direct Selling Association on the reasons consumers join MLMs. The court twice sustained objections to this evidence. Vander Nat, 10 RT 115-16 [69 ER 1005-06]; Luce, 16 RT 73-74 [57 ER 0770-71].

Now, on appeal, the DSA has submitted an amicus curiae brief in which it asserts that a 2002 survey shows that 91% of MLM participants buy their companies' products for their own consumption. Brief Amicus Curiae of the Direct Selling Association in Support of Neither Party, 10 n.5, 21 ("DSA Br."). Judge Wu correctly excluded DSA's surveys as irrelevant to the trial, and this court should do the same on appeal. As discussed above, this Court's analysis in *Omnitrition* establishes that such internal sales do not save an otherwise unlawful pyramid scheme.

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*, 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 consequences" if it 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 sales 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). BurnLounge 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). *Stefanchik*, 559 F.3d at 931-32; *Pantron I Corp.*, 33 F.3d at 1102; *accord FTC v. Bronson Partners, LLC*, 654 F.3d 359, 365-67 (2d Cir. 2011); *FTC v. Direct Mktg. Concepts, Inc.*, 624 F.3d 1, 14-15 (1st Cir. 2010); *FTC v. Freecom Comm'ns, Inc.*, 401 F.3d 1192, 1202 n.6 (10th Cir. 2005); *FTC v. Febre*, 128 F.3d 530, 534 (7th Cir. 1997); *FTC v. Gem Merch. Corp.*, 87 F.3d 466, 468-70 (11th Cir. 1996); *FTC v. Sec. Rare Coin & Bullion Corp.*, 931 F.2d 1312, 1314-15 (8th Cir. 1991); *FTC v. Southwest Sunsites, Inc.*, 665 F.2d 711, 717-22 (5th Cir. 1982).

Though defendants cite *Great-West Life & Annuity Co. v. Knudson*, 534 U.S. 204 (2002), for the principle that the FTC must trace assets to defendants in

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[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, they offer 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 others to do the same." Decision, 23-24 [5 ER 0066-67].

Defendants attempt to rebut this by arguing that earlier versions of the compensation plan documents in Exhibits 8 and 10 offered the same rewards to Moguls who bought an Exclusive package level as to those who bought a VIP package. Thus, defendants claim, the additional $300 paid for the VIP package over and above the $129 cost of the Exclusive package offered no bonus advantage and was not tied to the business opportunity. BurnLounge Br. 23 & n.10, 64; Taylor Br. 12. But this argument is nothing more than defendants' attempt to relitigate their case using a different strategy from that they pursued at trial.[26] At trial, defendants could not have been more clear that they relied on the version of the compensation plan embodied in Exhibits 8 and 10. In two separate colloquies defendants and Judge Wu discussed the importance of this version. In the first, counsel for BurnLounge stated, "Well, Your Honor, there were some material

[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].

changes and, again, we haven't given you all the iterations, but, as I said, our defense will rely on two sets of them." DeBoer, 6 RT 45-46 [8 SER 038-39] (referring to Exhibits 8 and 10 and later versions); *see also* Vander Nat, 10 RT 148-49 [13 SER 127-28]. Exhibits 8 and 10 were also the ones used by BurnLounge's expert Luce. Luce, 16 RT 88-92 [20 SER]. Having made the strategic decision to limit its case, defendants cannot now change theories in anticipation of a better outcome.

Defendants incorrectly claim that the court erred in not offsetting its harm calculation for commissions paid by BurnLounge to Moguls. BurnLounge Br. 62. As the court explained, its calculation did not subtract for commissions paid *to* Moguls, but did not add in the $6.95 monthly fees received *from* Moguls either. Decision, 27 n.47 [5 ER 0070]. The court excluded these amounts because they related to both the legitimate and illegitimate parts of the business and because these amounts were roughly equivalent, thus offsetting each other. *Id.* (citing Ex. 330 [45 ER]).[27] Thus, the court's calculation accounted for commissions, a

[27] Ex. 330 [45 ER] shows that BurnLounge paid out $17,316,980 in commissions to Moguls, and received $2,869,043 in monthly Mogul fees. *See also* Ex. 1051 [40 ER] (same). As the court also recognized, however, 85% of the commissions paid went to the top 6% of Moguls – all of whom had a positive net reward. Decision, 16 [5 ER 0059] (citing Ex. 421 [38 SER], Vander Nat, 9 RT 14-15 [12 SER 106-07]). The commissions paid to Moguls with a negative net reward therefore totaled $2,597,547 (or 15% of $17,316,980), which, though slightly less than the fees paid to BurnLounge, nonetheless roughly approximates that amount.

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 on 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. *Sec. 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*

Star Auto Club, 97 F. Supp. 2d at 530 (quoting *Figgie*, 994 F.2d at 605-06).

IV. The court properly calculated disgorgement amounts for defendant Arnold.

An individual may be personally liable for injunctive relief under Section 5(a) of the FTC Act if he participated directly in the corporation's acts or practices, or had authority to control them. *FTC v. Cyberspace.com, LLC*, 453 F.3d 1196, 1202 (9th Cir. 1996) (citing *FTC v. Publishing Clearing House, Inc.*, 104 F.3d 1168, 1170-71 (9th Cir. 1997)). Further, he may be subject to equitable monetary relief if he "had actual knowledge of material misrepresentations, [was] recklessly indifferent to the truth or falsity of a misrepresentation, or had an awareness of a high probability of fraud along with an intentional avoidance of the truth." *Publishing Clearing House*, 104 F.3d at 1171. Performance of the duties of a corporate officer is probative of an individual's participation or authority, and the degree of participation in corporate affairs is probative of knowledge. *FTC v. Affordable Media*, 179 F.3d 1228, 1235 (9th Cir. 1999); *Amy Travel Serv., Inc.*, 875 F.2d at 573-74; *FTC v. American Standard Credit Sys., Inc.*, 874 F. Supp. 1080, 1089 (C.D. Cal. 1994). The FTC is not required to prove a subjective intent to defraud; reliance on counsel or other claims of good faith are not defenses. *Amy Travel*, 875 F.2d at 574-75; *Cyberspace.com*, 453 F.3d at 1202.

The court below correctly applied these standards to defendant Arnold. As

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 BurnLounge as the "boss" and "ultimate authority." Decision, 28 [5 ER 0071]. Under these circumstances, Arnold's participation and knowledge are evident, and he is therefore subject to equitable monetary relief. *Publishing Clearing House, Inc.*, 104 F.3d at 1170-71.[28]

Moreover, Arnold's claims that he lacked an intent to deceive consumers or could not have known BurnLounge was a pyramid are not defenses. *See*, *e.g.*, *Amy Travel*, 875 F.2d at 574-75. As the court noted, knowledge and intent follow from an inherently fraudulent nature of a pyramid scheme as a matter of law. Decision, 28 [5 ER 0071] (citing *Omnitrition*, 79 F.3d at 788).

In any event, the evidence plainly refutes him. Arnold was deeply experienced in multilevel marketing businesses and thus would be familiar with the risks associated with pyramid schemes. Arnold, 6 RT 137-142 [9 SER 049-54]. Moreover, Arnold himself "[s]pearheaded" the compensation plan that resulted in the pyramid scheme. Arnold, 7 RT 12 [10 SER 058]. He knew others had

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[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 as validation for BurnLounge a Billboard Magazine article that commented on the possibility BurnLounge was a pyramid. Arnold, 7 RT 99 [10 SER 065]; Ex. 253 [28 SER]. BurnLounge's own documents addressed the issue. Ex. 1015 [13 ER 0355]. And it was Arnold's decision to send counsel to meet with the South Carolina Attorney General to address consumer complaints alleging BurnLounge was a pyramid. Jones, 1 RT 17-20 [1 SER]; Arnold, 7 RT 33-35 [10 SER 059-61]. For these reasons, Arnold's claims that he could not have known BurnLounge was a pyramid fall flat.

For these reasons, the district court correctly found that Arnold was jointly and severally liable with BurnLounge for the full amount of consumer harm it determined. Nonetheless, Arnold also challenges the $1,664,506.45 ordered by the court as an alternative disgorgement amount, claiming there was no support in the evidentiary record. BurnLounge Br. 65. The FTC offered the following stipulated facts and testimony from Arnold:

- Arnold's wages in 2006-2007 were $568,941.95. Dkt. 353-2 at ¶ 5(g) [82 ER 1090].
- Arnold's bonus in 2005 was $202,500.00. Arnold, 7 RT 67 [10 SER

064].

- Arnold's expenses reimbursed by BurnLounge totaled $893,124.50. Arnold, 7 RT 66 [10 SER 063]; Dkt. 353-2 at ¶ 5(h) [82 ER 1090]; Ex. 55.[29]

Arnold offered no affirmative evidence to contradict this at trial. Moreover, even if Arnold were correct, the district court nonetheless had broad discretion to fashion this relief. *Stefanchik,* 559 F.3d at 931. Having already found Arnold jointly and severally liable with BurnLounge for over $16 million, this alternative figure was no abuse.

V. The court erred in determining the amount of disgorgement owed by defendant DeBoer. [FTC Cross-Appeal No. 12-56228]

The court correctly ordered that DeBoer disgorge money he received through BurnLounge. In setting the amount, however, the court seriously erred. Disregarding undisputed evidence that DeBoer received $908,293.69, the court nonetheless ordered that DeBoer disgorge only $150,000. Decision, 30 [5 ER 0073]. The court did so for several reasons. First, the court noted that DeBoer was essentially only a participant. Decision, 29 [5 ER 0072]. Second, the court found

[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* Arnold, 7 RT 66 ("Q: Okay. Let me ask you. The total is 893,000 and some change; is that correct? A: Yes.") [10 SER 063].

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 manifest. He testified about his considerable sales activities and his resulting successes. DeBoer, 6 RT 35-40 [8 SER 032-37]. Moreover, DeBoer was considered a leader and was deeply involving in marketing and training. Keranen, 13 RT 299 [15 SER]; Ex. 1163 [19 ER]. The evidence of his knowledge was also substantial. DeBoer knew there were allegations BurnLounge was a pyramid; in fact, concerned about this, he consulted the FTC's website for guidance and considered retaining counsel. DeBoer, 6 RT 29-30, 59-60, 131-34 [8 SER 029-30, 043-48]. DeBoer admitted that he discussed the pyramid allegations during his

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*, 559 F.3d at 931.

Finally, the district court erred in finding the FTC did not provide any evidence which identified "either the individuals who were in fact mislead [sic] by DeBoer or the amounts of their loss." Decision, 29 [5 ER 0072]. The FTC sufficiently proved reliance in this case is not required to prove each consumer's subjective reliance. *Sec. Rare Coin & Bullion Corp.*, 931 F.2d at 1316; *Figgie*, 994 F.2d at 605-06. These facts are sufficient to establish DeBoer's liability for the full amount of his receipts.

VI. The court properly ordered defendant Taylor to disgorge his full receipts.

The court found that, although Taylor was not an officer or employee, he was nonetheless directly and centrally involved in the business, and it ordered him to disgorge his receipts from the scheme. Decision, 28-29 [5 ER 0071-72] (citing *Pantron I Corp.*, 33 F.3d at 1102). As the court itself recognized, this was a proper exercise of its equitable authority. "[T]he authority granted by section 13(b) is not limited to the power to issue an injunction; rather, it includes the 'authority to grant any ancillary relief necessary to accomplish complete justice.'" 33 F.3d at 1102.

Taylor claims that the court erred in not treating him like DeBoer and allowing offsets for expenses or earnings from music sales outside of the pyramid.

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 pyramid, 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.*, 179 F. Supp. 2d 1149, 1157 (C.D. Cal. 2001) ("expenses in carrying out a fraudulent scheme . . . are hardly appropriate or legitimate deductions")). In doing so, this Court affirmed disgorgement from an individual of his proceeds – not net profits – even though the defendant ultimately lost $1.2

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 $908,293.69 – the full amount of his receipts from the illegal scheme.

Respectfully submitted,

DAVID C. SHONKA
Acting General Counsel

JOHN F. DALY
Deputy General Counsel for Litigation

s/ Burke W. Kappler

BURKE W. KAPPLER
Attorney
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580
202-326-2043

OF COUNSEL:
CHRIS COUILLOU
DAMA BROWN
Federal Trade Commission
Southeast Region Office

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
BURKE W. KAPPLER
Attorney
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580
202-326-2043

April 1, 2013

9th Circuit Case Number(s) 12-55926 (Consolidated with 12-56197 and 12-56288)

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Rob DeBoer, 316 Amberwood Circle, Irmo, SC 29063
(by FedEx and e-mail to coachrobdeboer@gmail.com)

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