No. 12-56228

IN THE

United States Court of Appeals for the Ninth Circuit

FEDERAL TRADE COMMISSION,
Plaintiff-Cross-Appellant,

v.

BURNLOUNGE, INC., *et al.*,
Defendants-Appellants.

On Appeal from the United States District Court
for the Central District of California
(George H. Wu, J.)
No. 07-CV-03654

BRIEF AMICUS CURIAE OF THE DIRECT SELLING ASSOCIATION IN SUPPORT OF NEITHER PARTY

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Dated: January 11, 2013

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RULE 26.1 CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, amicus makes the following disclosure statement:

The Direct Selling Association is a not-for-profit organization. It has no parent corporation, and no publicly held corporation owns 10% or more of its stock.

Dated: January 11, 2013

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BRIEF AMICUS CURIAE OF THE DIRECT SELLING ASSOCIATION IN SUPPORT OF NEITHER PARTY

STATEMENT OF INTEREST OF AMICUS CURIAE[1]

The Direct Selling Association (DSA) is a 102-year-old national trade association headquartered in Washington, D.C. DSA represents companies that distribute products to customers through or with the assistance of independent

[1] Pursuant to Fed. R. App. P. 29, amicus certifies that all parties have consented to the filing of this brief. Amicus likewise certifies that no party's counsel authored this brief in whole or in part; no party or party's counsel contributed money intended to fund the brief's preparation or submission; and no person other than amicus and its members and counsel contributed money intended to fund the brief's preparation or submission.

salespersons who personally demonstrate and explain those products to the consumer, usually in the home or work place. Direct sellers are perhaps best known to the public as person-to-person, door-to-door, or home party plan sellers. Through the efforts of direct salespersons who provide personal demonstration, home delivery, and a variety of other sales-related services, direct-selling companies can offer quality products to consumers without substantial advertising or other barriers to entry found in other distribution systems, like brick-and-mortar stores.

In 2011, over 15.6 million individuals sold directly, often as a second, third, or even fourth source of income, collectively generating over $29 billion in estimated retail sales value. Of the millions of individuals involved in direct sales, over 78 percent are female. See DSA, 2011 Direct Selling Industry-Wide Growth and Outlook Survey Fact Sheet.[2] DSA estimates that its 186 member companies account for more than 90 percent of the industry's annual sales volume.[3] At least 10 members of DSA are publicly traded companies.

Individuals become direct salespersons for many reasons, but one primary reason is the desire to purchase and use the company's products at wholesale or discount prices. See DSA, 2002 Direct Selling Industry – National Sales Force

[2] Available at http://www.dsa.org/research/industry-statistics/11gofactsheet.pdf.

[3] BurnLounge is not and has never been a member of DSA.

Survey.[4] Wholesale or discount buyers thus can make up a significant portion of a direct-selling company's customer and distributor base. Others join direct-selling to fulfill personal short-term objectives (for example, working in December to earn holiday gift money). The ease of entry into and exit from the direct-selling business facilitates this type of sales activity. Some use the industry as a year-round supplemental income source, but only work a few hours per week. Their extra direct-selling income improves the quality of their lives, often keeping them in the middle class. Others pursue their businesses as careers, devoting 30 hours or more a week to the business. Yet other individuals start direct-selling businesses to gain social contacts or recognition otherwise missing in their lives. Finally, many consumers of direct-selling company products so believe in those products that they are driven to share them with family, friends, and neighbors.[5] People can move in and out of these categories and can be in more than one category simultaneously.

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[4] Available at http://www.dsa.org/research/industry-statistics/?fa=01numbers.

[5] DSA's 2008 survey of individuals involved in direct-selling, for example, found that 78 percent of individual direct-sellers entered direct-selling because they used the products before becoming a distributor. DSA's 2002 survey found that 91 percent of direct salespersons purchase their company's products for personal consumption and use, and that such personal consumption and use by direct salespersons and their families constituted nearly one-third of total direct-selling company sales.

A significant percentage of DSA members employ compensation plans where customers are offered the opportunity to share their enthusiasm for the company's products and to receive rewards from sales to those consumers, and to other consumers who in turn buy from those consumers. In short, a direct-selling company must successfully persuade its own salespersons of the quality and value of its products for them effectively to market those products to others.

DSA has worked for decades to help develop clear and reasonable standards which law enforcement officials, legislators, legitimate businesses, and the public may use to distinguish unlawful pyramid schemes from legitimate direct-selling companies and to identify and prosecute unlawful pyramid schemes. Over the last twenty years DSA has worked with state legislatures to pass legislation identifying and condemning unlawful pyramid schemes. In 2003 DSA successfully worked with legislators in South Dakota to pass an anti-pyramid promotional scheme law. The Council of State Governments (CSG), one of the country's preeminent state public policy organizations, adopted this legislative language in its 2004 Volume of Suggested State Legislation. See 63 CSG, Suggested State Legislation 111 (2004). This CSG model legislation was subsequently enacted into law in Idaho, Georgia, Utah, and Washington. See Idaho Code § 18-3101; Ga. Code § 16-12-38; Utah Code § 76-6a; Wash. Rev. Code §§ 19.275.010-19.275.030. And in 2011,

with the strong support of the Nebraska Attorney General, Nebraska adopted the CSG model pyramid scheme legislation as law. Neb. Rev. Stat. § 87.302(a)(12).

In conjunction with the Direct Selling Education Foundation (DSEF), a non-profit consumer education organization, DSA has co-authored many publications (often in cooperation with law enforcement and other public and quasi-public agencies) to educate the public on the differences between pyramid schemes and legitimate multi-level companies and how to identify and avoid unlawful pyramid schemes. See, e.g., " Legitimate Direct Selling vs. Illegal Pyramid Schemes – A White Paper"[6]; "Legitimate Direct Selling Companies Offer Many Consumer Protections"[7]; "Pyramid Schemes: Not What They Seem" (1991) (published in cooperation with the Federal Trade Commission and the National District Attorneys Association); "Promises. Check 'em Out!: Business Opportunity Fraud: (1994) (published in cooperation with the National District Attorneys Association). See also Mario Brossi & Joseph N. Mariano, Multilevel Marketing - A Legal Primer (2d ed. 1997).

DSA also participates as an amicus curiae in this and other litigation involving direct-selling issues. See, e.g., Webster v. Omnitrition Int'l, Inc., 79 F.3d 776 (9th Cir. 1996) ("Omnitrition"); State ex rel. Miller v. American Prof'l

[6] Available at http://www.dsa.org/ethics/internalconsumptionwhitepaper.pdf.

[7] Available at http://www.dsa.org/ethics/consumerprotections.pdf.

Mktg., Inc., 382 N.W.2d 117 (Iowa 1986), and In re Ger-Ro-Mar, Inc., 84 F.T.C. 95 (1974). DSA submits this brief as part of its ongoing efforts to put a stop to unlawful pyramid schemes and to ensure that the public continues to enjoy the benefits of the many products legitimate direct-selling companies offer.

DSA takes no position on the merits of this case. Instead, it will focus solely on the ramifications of an overly broad application of one sentence in the definition of a "Prohibited Marketing Scheme" in the District Court's amended final judgment and order that is the subject of this appeal: "For purposes of this definition, 'sale of products or services to ultimate users' does not include sales to other participants or recruits or to the participants' own accounts." Amended Final Judgment and Order for Permanent Injunction and Other Equitable Relief (filed 03/01/12) (Amended Final Judgment) at 5. This sentence has potentially significant adverse consequences for DSA's many legitimate direct-selling company members, because it appears to prohibit compensation based on purchases by participants or on sales by one participant to another. That prohibition has been used as a remedial measure in certain circumstances involving proven pyramid schemes. But if it becomes embedded in the definition of "pyramid scheme" itself, that would present grave concerns. Whatever this Court's decision on the merits of BurnLounge's appeal and the FTC's cross-appeal, it would harm hundreds of legitimate businesses—and millions of their consumers and salespersons—to

endorse the conclusion that legitimate direct-selling companies that base compensation at least in part on product purchases by direct salespersons for their personal consumption and use are unlawful "pyramid schemes."

ARGUMENT

In concluding that BurnLounge, Inc. operated an unlawful pyramid scheme, the District Court adopted the definition of a "pyramid scheme" set out in the FTC's decision In re Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975), affirmed in Turner v. FTC, 580 F.2d 701 (D.C. Cir. 1978) (Koscot), and approved by this Court in Omnitrition, 79 F.3d 776:

> [Pyramid schemes] are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product *and* (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users. [Op. 19.]

The District Court then analyzed the particular facts of BurnLounge's compensation plan to determine whether the plan met that definition. Id. at 20-23.

DSA generally agrees with and supports both the "pyramid scheme" definition the District Court adopted and the type of fact-specific analysis the court employed in determining whether that definition applied to BurnLounge's plan. DSA further agrees with the District Court's view that if salesperson compensation were tied to recruitment and unrelated to the sale of product to ultimate users, it could be pyramidal in nature. But DSA is concerned that the District Court

ultimately adopted an order which, if applied to legitimate direct-selling companies, could preclude those companies from providing wholly lawful compensation based on their direct salespersons' purchases of the companies' products for their personal consumption and use. We will discuss each of those points in more detail below.

The definition of a "pyramid scheme." The general definition of a "pyramid scheme" is well settled at both the federal and state level. Federal courts regularly hew to the definition put forward in Koscot and adopted by this Court in Omnitrition. And every state in the United States (except New Jersey) has enacted laws defining pyramid schemes and prohibiting them from being marketed in the state.[8] The definitions vary from state to state, but most define a pyramid scheme similarly to the description accepted in Omnitrition:

[8] *See* Ala. Code § 8-19-5(19); Alaska Stat. § 45.50.471(b)(19); Ariz Rev. Stat. § 44-1731; Ark. Code §4-88-109; Cal. Penal Code § 327; Colo Rev. Stat. §§ 6-1-102(9), 6-1-105(1)(q); Conn. Gen. Stat. § 42-145; Del. Code Title 6, §§ 2561-2564; Fla. Stat. § 849.091(2); Ga. Code § 16-12-38; Haw. Rev. Stat. § 480-3.3; Idaho Code § 18-3101; Ill. Comp. Stat. ch. 815 para. 505/1(g), 505/2A; Ind. Code § 24-5-0.5; Iowa Code § 714.16.2.b; Kan. Stat. § 21-5838; Ky. Stat. § 367.830; La. Rev. Stat. § 51:361(6); Me. Rev. Stat. Tit. 17, § 2305; Md. Code Crim. Law § 8-404; Mass. Laws Ch. 93 § 69; Mich. Comp. Law § 445.1528; Minn. Stat. § 325F.69(2); Miss. Code §§ 75-24-51–75-24-53; Mo. Stat. §§ 407.400–407.405; Mont. Code §§ 30-10-324–30-10-325; Neb. Rev. Stat. §§ 87-301–87-302; Nev. Rev. Stat. §§ 598.100-598.130; N.H. Rev. Stat. § 358-B; N.M. Stat. § 57 Art. 13; N.Y. Gen. Bus. Law § 359-fff; N.C. Gen. Stat. § 14-291; N.D.C.C. § 51-16.1.01; Ohio Rev. Code §§ 1333.91-1333.94; Okla. Stat. tit. 21, § 1071; Or. Rev. Stat. § 646.609; Penn. Stat. Tit. 73, § 201-2(4)(xiii); R.I. Stat. §§ 6-29-1–6-29-3; S.C. Code § 39-5-30; S.D. Cod. Law § 37-33-3; Tenn. Code § 39-17-506(3)(b); Tex.

> a plan or operation in which a participant gives consideration for the right to receive compensation that is derived primarily from the recruitment of other persons as participants in the plan or operation rather than from the sale of goods, services, or intangible property to participants or by participants to others.[9]

As both the federal and state definitions make clear, the obvious evil of a pyramid scheme is that it bases compensation only on recruiting additional participants—not on sales of products to end users. Most typically, as in Koscot, participants in an illegal pyramid scheme are required to make large up-front investments to buy into the plan through fees not associated with the purchase of a product, or through "inventory loading" (meaning sales of excessive amounts of product to participants). Participation in a pyramid scheme thus grows geometrically—but without any actual demand for the scheme's products (if there even are products). With no viable economic engine to drive profits and payments for later-entering participants, the scheme collapses as the pool of available participants dries up.

Bus. & Commerce Code § 17.461; Utah Code § 76-6a(4); Vt. Stat. 9 § 2453; Va. Code § 18.2-239; Wash. Rev. Code §§ 19.275.010-19.275.030; W.V. Code § 47-15; Wis. Stat. § 945.12; Wyo. Stat. §§ 40-3-102 – 40-3-107.

[9] *See* Ala. Code § 8-19-5(19); Ariz Rev. Stat. § 44-1731; Ark. Code § 11-4-203; Fla. Stat. § 849.091(2); Ga. Code § 16-12-38; Idaho Code § 18-3101; Ill. Comp. Stat. ch. 815 para. 505/1(g), 505/2A; Kan. Stat. § 21-5838; La. Rev. Stat. § 51:361(6); Md. Code Crim. Law § 8-404; Mass. Laws Ch. 93 § 69; Miss. Code §§ 75-24-51–75-24-53; Mo. Stat. §§ 407.400–407.405; Mont. Code §§ 30-10-324(6)(a); Neb. Rev. Stat. §§ 87-301–87-302; N.M. Stat. § 57 Art. 13(2); N.D.C.C. § 51-16.1.01; Okla. Stat. tit. 21, § 1071; S.D. Cod. Law § 37-33; Tex. Bus. & Commerce Code § 17.461; Utah Code § 76-6a; Va. Code § 18.2-239; Wash. Rev. Code §§ 19.275.010–19.275.030.

Analyzing whether a compensation plan is a "pyramid scheme." As the District Court recognized in this case, " '[w]hether a plan or program operates as a pyramid scheme is determined by how it functions in practice.' " FTC v. BurnLounge, CV 07-3654-GW(FMOx) (July 1, 2011), at 20 (quoting Whole Living, Inc. v. Tolman, 344 F. Supp. 2d 739, 745 (D. Utah 2004)). And although the definition of a "pyramid scheme" is relatively clear and consistent, actually applying that definition to distinguish an unlawful pyramid from a legitimate market plan can be more complicated. Doing so requires a detailed factual analysis of the substance, actual operation, and enforcement of the plan and any precautionary rules designed to maintain a focus on product sales to end users. As the District Court put it, "[a] lawful [direct-selling company] is distinguishable from an illegal pyramid scheme in the sense that the 'primary purpose' of the [lawful] enterprise and its associated individuals is to sell or market an end-product with end-consumers, and not to reward associated individuals for the recruitment of more marketers or 'associates.' " Id. at 20 (quoting FTC v. SkyBiz.com, Inc., 2001 U.S. Dist. LEXIS 26185, at *28 (N.D. Okla. Aug. 31, 2001)).

The complication in applying this guidance often arises because many legitimate direct-selling companies nominally calculate compensation based on the amount of purchases their direct salespersons make for their own use and consumption and/or for resale. While compensation based on salesperson

purchases alone could potentially support pyramid charges in some circumstances, legitimate direct-selling companies adopt and enforce a variety of rules in their compensation plans to ensure that the plans' rewards and incentives in fact depend on the ultimate sale of products to end users. These rules ensure that compensation based on salesperson purchases is paid only if those purchases in fact ultimately result in the use and consumption of the products by end users, whether the salespersons themselves or others to whom they resell the products, ensuring that compensation is based on actual consumer demand for the products, and not some impermissible metric.

The Federal Trade Commission underscored the importance of effective enforcement of such rules over 30 years ago in In re Amway Corporation, Inc., 93 F.T.C. 618 (1979), a decision that set the standard for the types of rules a legitimate direct-selling company might adopt and enforce to ensure that the compensation it pays to its salespersons is ultimately based on the sale of products to end users, not on the mere act of recruitment. As the FTC's decision explains, Amway appeared to calculate compensation based on the purchases, not the sales, its salespersons made. *See* 93 F.T.C. at 645 (Administrative Law Judge Initial Decision ¶ 61), 712 (Opinion of Commission) ("Under the Amway Plan, each distributor is eligible to receive a monthly 'Performance Bonus' which is based on the total amount of Amway products he purchased that month for resale, both to

consumers and to his sponsored distributors"). But the Commission nevertheless concluded that Amway did not operate a pyramid scheme because the rules Amway adopted and enforced effectively ensured that compensation under the Amway plan was ultimately based on sales of products to end users. See id. at 646 (ALJ Initial Decision ¶¶ 72-75), 667-668 (ALJ Initial Decision ¶¶ 142-147), 715-717 (Opinion of Commission). By contrast, in Omnitrition, this Court held the target company's mere adoption of some similar rules was insufficient to sustain dismissal of pyramid scheme allegations, where the company had failed to show its rules were actually effective and enforced. Omnitrition, 79 F.3d at 782-784.[10]

The need for care when considering the legality of compensation based on personal use and consumption of a company's products by its direct salespersons. As noted above, DSA takes no position on whether the District Court correctly analyzed and applied the definition of a "pyramid scheme" in this case. But DSA has grave concerns about one sentence in the District Court's amended final

[10] DSA does not suggest that the mere adoption of Amway-type rules guarantees that a plan is not a pyramid, or that the adoption of other types of rules could not be sufficient for a plan to be legitimate. The key in each instance is that whatever rules a company may adopt be structured and enforced in a manner that effectively ensures that compensation under the plan is ultimately focused and dependent on sales to end users. Thus, while the types of rules in Amway are one good benchmark of the goals to be achieved and possible ways to achieve them, they do not dictate the only way those goals may be achieved in the context of any individual plan.

judgment and order if it were construed to apply in the case of legitimate multi-level marketing plans.

The District Court's order specifically prohibits BurnLounge and the other individual defendants from engaging in a "Prohibited Marketing Scheme." Amended Final Judgment § I. "Prohibited Marketing Scheme" is defined in terms virtually identical to the definition of a "pyramid scheme" set forth in Koscot and Omnitrition. Id. at 5 (Definitions ¶ 19). But the order then adds a final sentence defining which "ultimate users" may qualify as end users upon whose purchases compensation may be based:

> For purposes of this definition, "sale of products or services to ultimate users" does not include sales to other participants or recruits or to the participants' own accounts. [Id. ¶ 19 at 5 (emphases added).]

This last sentence has potentially significant consequences for DSA's many legitimate direct-selling company members. Its prohibition on compensation based on purchases by participants or on sales by one participant to another may be appropriate only as a remedial measure in some circumstances in which a plan has already been determined to be a pyramid. But if that sentence becomes embedded in the standard definition of a "pyramid scheme" itself—thus prohibiting compensation based on personal use and consumption of a direct-selling company's products by its salespersons in all circumstances—it threatens to

impose substantial and unwarranted injury on legitimate direct-selling companies and their salespersons and customers. This is so for several reasons.

First, as the Federal Trade Commission made clear long ago in Amway, there is nothing inherently wrong with compensation calculated on the basis of salespersons' purchases of the company's products where the sales plan in question is structured and enforced in a manner that ensures the compensation is ultimately based on sales to end users. See supra at 11 & n. 6. This makes sense. Salespersons who are satisfied purchasers of a direct-selling company's products for their own personal consumption and use are no less "end" or "ultimate" users of the products—and no less a source of legitimate and real retail demand for the company's products—than consumers who have no other relationship with the company. As explained above, a legitimate direct-selling company's sales of products to its own salespersons for their personal consumption and use are of substantial importance for that company. See supra at 3 & n.3 (citing a 2002 study concluding that fully 91 percent of direct salespersons purchase their company's products for personal consumption and use, and that personal consumption and use by direct salespersons and their families constitutes nearly one-third of total direct-selling company sales). The enthusiasm those sales generate for the company and its products are an essential contributor to its salespersons' desire and ability to sell the company's products, and to recruit others to do so.

Second, as the Federal Trade Commission has confirmed in a 2004 advisory opinion to DSA,

> [t]he amount of internal consumption in any multi-level compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme. The critical question for the FTC is whether the revenues that primarily support the commissions paid to all participants are generated from purchases of goods and services that are not simply incidental to the purchase of the right to participate in a money-making venture. [FTC Staff Advisory Opinion to DSA (Jan. 14, 2004), at 1 (emphasis added).]

The advisory opinion defines "internal consumption" as "personal consumption by members of a multi-level company's sales force." Id. at 1. See also Whole Living, Inc. v. Tolman, 344 F. Supp. 2d 739, 745 (D. Utah 2004) ("A structure that allows commission on downline purchases by other distributors does not, by itself, render a multi-level marketing scheme an illegal pyramid").

Third, there is not a single state anti-pyramid law that prohibits compensation based on internal or personal consumption of plan participants. In fact, numerous states' laws specifically recognize that compensation based on direct salespersons' purchases for personal consumption and use is a lawful practice of legitimate direct-selling companies.[11]

For all of these reasons, it could unjustly injure legitimate direct-selling companies, their salespersons, and the consumers they serve, to apply the last

[11] See supra at 4.

sentence of the District Court's definition of a "Pyramid Marketing Scheme" to assess whether any given direct-sales plan is legitimate or an unlawful pyramid scheme.

CONCLUSION

For all of the foregoing reasons, if this Court concludes that it will affirm the District Court's judgment and order, DSA respectfully requests that this Court not state or imply that payment of compensation based on direct salespersons' purchases of their company's products for their personal consumption and use is inherently or necessarily inappropriate or unlawful.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH RULE 32(A)

Pursuant to Fed. R. App. P. 32(a)(7)(C), I hereby certify that this brief was produced in Times New Roman 14-point typeface using Microsoft Word 2003 and contains 3,677 words.

/s/ Catherine E. Stetson
Catherine E. Stetson

CERTIFICATE OF SERVICE

I hereby certify that on this 11th day of January 2013, the foregoing Brief for Amicus Curiae was filed with the Court's ECF system, and accordingly was served electronically on all parties.

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