

FTC v. BurnLounge: Lessons Learned for MLM/Direct Selling

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FTC v. BurnLounge: 10 point mini-primer and action plan on the "personal use" issue:

1. FTC stated policy has been to prosecute egregious pyramid schemes as opposed to mainstream direct selling. By and large, this has been the case since the famous 1979 FTC Amway unsuccessful prosecution.
2. FTC and major court pyramid decisions, including FTC v. BurnLounge, focus on front-loading, large investments, products and services that do not stand on their own in the marketplace, payment of recruitment commissions for purchases of nonconsumer items such as sales tools, unsubstantiated earnings claims and programs where the motivation for distributor product purchases is driven by intent to "buy in" and qualify for commissions in the business opportunity ... and is incidental to a real desire for product or service for resale or personal use.
3. The existence of distributor purchases of consumer products and services, in reasonable amounts, for "personal use" is common in the direct selling industry and does not appear to be a driving "pyramid" criticism of the FTC or court decisions.
4. Notwithstanding the absence of "personal use" criticism, a disconnect exists"; it is common place, in FTC and pyramid cases, to issue orders that provide that distributor "personal use" purchases should not be recognized as "sales to ultimate users" for purpose of determining if a program is a pyramid or legitimate.
5. Overreaching on the "personal use" issue creates a cloud of legal uncertainty for the direct selling industry and the livelihoods of millions of distributors.
6. The BurnLounge Final Order continues this "disconnect" and perpetuates an unnecessary cloud of legal uncertainty on the role of "personal use" in pyramid analysis.
7. The BurnLounge Final Order is sure to be cited in future FTC actions, state, federal and international regulatory actions, class actions and private lawsuits, proposed state, federal and international laws, regulations and rules.
8. Prior uncertainty from previous FTC actions and other cases have prompted multiple states to recognize legitimacy of personal use, creating confusion between states and between federal and state on this issue. As early as 1986, the state of California recognized "reasonable personal use" in a stipulated order involving Herbalife. And even

Overreach of BurnLounge Final Order creates uncertainty on "personal use" issue...

the FTC, in 2004, clarified, in a FTC Staff Advisory Opinion, that it did not necessarily object to personal use, and noted that it tended to overreach in court cases in order to achieve stronger flexibility in prosecutions of egregious pyramid schemes.

9. In 2003, the industry introduced proposed federal clarification legislation, HR 1220 to recognize personal use and remove the disconnect and uncertainty; the industry, specifically the DSA, should again initiate such proposed federal legislation.
10. In the alternative, the FTC and DSA, with permission of the BurnLounge defendants, should seek to amend the BurnLounge Final Order to recognize that "sales to the ultimate consumer" include distributor purchases in reasonable amounts for personal use.

And now, the context ...

The FTC v. BurnLounge Saga

In March, 2012, after a five-year journey started in 2007, the end of the saga of FTC v. BurnLounge came to a dramatic conclusion with a stunning judgment of \$17 million against the MLM digital music seller and its owners.

It is likely that neither the direct selling industry nor the music industry wept any tears, as the BurnLounge phenomenon was viewed by various observers as an outlier to the direct selling model, portrayed by the Court and FTC as the facade of an online MLM direct seller of music downloads in which the revenue of music sales to consumers was absolutely incidental to the true model in which distributors purchased varying "packages," ranging from \$29.95 to \$429.95, plus monthly fees, and were rewarded for recruiting other distributors to do the same, and so on. This actual model, said the court and FTC, fit the classic definition, not of a legitimate direct selling business model, but rather that of an illegitimate pyramid headhunting recruitment scheme in which profits were made by distributors recruiting each other to pay large sums of money that they might not ordinarily pay, but for the earning opportunity.

In other words, argued the FTC and the Court, the products sold did not stand on their own in the marketplace and the Court made sure to point out that the overwhelming revenue did not come from digital music sales to the consuming public, but rather from "package purchases" by distributors.

Said the FTC in its 2012 Press Release:

At the request of the Federal Trade Commission, a U.S. district court judge has ordered the operators and top promoters of a deceptive pyramid scheme to pay a total of \$17 million to refund consumers who were burned by the scam. The court order permanently halts marketing methods used by the operation known as BurnLounge, which lured more than 56,000 consumers

from around the country by masquerading as a legitimate multi-level marketing program and making misleading claims about earnings to be made.

*The FTC filed a complaint against BurnLounge in 2007 as part of its ongoing efforts to protect consumers from fraud and deception. BurnLounge had touted itself as a cutting-edge way to sell digital music through multi-level marketing, but music sales accounted for only a small percentage of its sales. The agency charged that BurnLounge recruited consumers from across the country by telling them that participants earned huge incomes. **Investors could buy into the BurnLounge organization for prices ranging from \$29.95 to \$429.95, plus monthly fees. While participants were compensated for music and album sales, most compensation came from recruiting others into the plan.***

And, although the direct selling industry has had its disagreements with the FTC, it is understandable that there may be few in the industry that would not be on the same wavelength as the FTC and Court on this episode. It made sense from the standpoint of an industry observer that this case fell in line with other FTC prosecutions of "egregious" pyramid schemes such as FTC v. Equinox (\$5,000 inventory "front-loads") and FTC v. Skybiz (millions of website hosting packages sold with only a tiny fraction activated for use by real customers) or the U.S. criminal prosecution of Gold Unlimited, which paid huge rewards for down payments on undelivered gold bullion contracts.

The direct selling industry will not weep for the demise of programs that courts have ruled to be "over the top." However, it will live with the taint of such practices that, during their brief existence, masquerade as legitimate MLM companies, draining good recruitment candidates, but more importantly tainting future recruitment opportunities because of the "bad taste" left with the public.

But more important to the industry, such cases, often inadvertently, leave behind undeserved tiny nuggets of unjustified and "just plain wrong" legal precedent that wreak havoc and uncertainty for the legitimate direct selling industry for years to come. And so it happened with FTC v BurnLounge. Buried in one line in the final judgment is a legal proposition that is, in actuality, in conflict with the FTC's stated position on legitimacy, the trial court's own written rationale for the decision and the direct selling industry's view on legitimacy ... all related to the recognition of the legitimacy of distributor product purchases, in reasonable amounts for "personal use."

All three, the FTC, the industry and the Burnlounge Trial Court opinion, would be in agreement that a program is a pyramid if the sale of product to distributors is driven by qualification for "rewards" rather than usage of the product or service. If the primary motivating factor for distributor purchases is qualifying in the business opportunity, a program is likely a pyramid headhunting recruitment scheme in which distributors recruit others to pay money and so on.

But one line, buried in the final judgment, sure to be cited in the future, removed all nuance and deliberate thought from this issue by ordering that "no distributor personal use product purchases" were even to be considered in evaluating legitimacy. And such language, if applied to the multi-billion dollar direct sales industry, could easily create legal challenge to many of the world's leading direct selling companies, many in business for decades and some even publicly traded on stock exchanges.

The Final Judgment Order language appeared as follows:

19. "Prohibited Marketing Scheme" means an illegal pyramid sales scheme, ... Ponzi scheme, chain marketing scheme, or other marketing plan or program in which participants pay money or valuable consideration in return for which they obtain the right to receive rewards for recruiting other participants into the program, and those rewards are unrelated to the sale of products or services to ultimate users. 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.

This last tagline, if adopted by other courts, is a "game changer" in analysis of pyramid vs. legitimate.

The Non-Recognition of Personal Use is a Disconnect from the BurnLounge Court Opinion and from FTC Positions on the Subject ... It Creates an Unnecessary Cloud on the Business Model and Operation of Many Major Direct Selling Companies

...

BurnLounge Opinion vs. Final Order Disconnect on Personal Use

By and large, the Court's statement of opinion accepted the FTC position that BurnLounge was a pyramid. However, there was a disconnect between the opinion and the "personal use" language in the Final Order. In fact, the thrust of the opinion was not based on criticism of the sort of "personal use" by distributors so common in many leading direct selling companies. Instead, the thrust of the opinion was that the motivation for distributor purchases of "packages" was incidental to creating a market for company product or services; rather the true purpose for purchases was to buy into qualification for commissions in the opportunity ... a classic allegation in pyramid schemes.

In fact, the Court's own observations even seemed to ratify distributor personal use, for the right reasons, as a favorable factor in legal analysis, also noting that products, purchased as sales tools, do not fit properly in the analysis:

The bundled products had at least some minor value in and of themselves, and a consumer who had primarily in mind that value when he/she purchased them could not have been harmed by the scheme. The Court therefore finds the fact that the products had some value is relevant to the calculation of consumer harm, but only insofar as those products were purchased for their value as ultimate user products, and not for the conjoined business opportunity.¹⁶ To individuals who considered the bundled products as merely incidental to the business opportunity, the Court finds the products were of no relevant value ...

*... BurnLounge argues that the sale of the Basic Package (i.e. the sale of an individual BurnPage and its required software) is the sale of a product to an ultimate user.³⁷ See *Whole Living, Inc.*, 344 F. Supp. 2d at 745-46 ("A structure that allows commission on downline purchases by other distributors does not, by itself, render a multi-level marketing scheme an illegal pyramid."). While it is true that the BurnPage could be considered a "product" and a Retailer to be the "user" of that product, this argument ignores the nature of the use itself. That is as a tool for sales and (more importantly) for recruitment, as demonstrated by a review of the BurnLounge promotional materials, the presentations of its spokespersons, and the statistics as to the participants who bought into the enterprise.*

A look at key observations, by the court, indicates that the pyramid finding was occasioned, not by personal use of actual consumer products as an ultimate user, but rather by activities common to pyramid schemes ... quoting the court:

Purchasing a website was one of the prerequisites to become a BurnLounge Retailer...

... because participation in the program required the purchase of a product package, and Moguls earned cash for selling these product packages to those they sponsored, they by default received compensation for recruiting others into the program.

The vast majority of Retailers (approximately 97%) chose to become Moguls for at least part of the time they participated in the BurnLounge enterprise ...

... once the multi-level business opportunity was removed, sales of the packages plummeted

... the FTC claims that the value of the products is irrelevant because they were all "incidental" to the business opportunity ...

To individuals who considered the bundled products as merely incidental to the business opportunity, the Court finds the products were of no relevant value.

BurnLounge ultimately recruited approximately 62,250 people into the Burn-Lounge program. 1,980 were only Retailers while 60,270 became Moguls. ... In the roughly two plus years of its operation, BurnLounge took in approximately \$28,386,280 million in revenue ... Music sales to Moguls accounted for \$489,083, while their sales of product packages brought in \$19,686,327.

The remaining revenue from Moguls came from the \$8.00 monthly fee charged for premium BurnLounge packages (totaling \$3,215,336), the \$6.95 monthly Mogul fees (totaling \$2,869,043), and miscellaneous merchandise purchases of \$857,268. Music sales to non-Mogul Retailers totaled \$13,581, while their sales of product packages totaled \$221,175. Music downloads to persons other than BurnLounge Retailers and Moguls generated \$1,000,576.

BurnLounge paid out \$17,458,276 in commissions. The top grossing 1% of the Moguls earned 66% of the commissions/bonuses, and the top grossing 6% of the Moguls received 85% of the commissions/bonuses ...

About 93.84% of all the Moguls (i.e. 56,557) never recouped their investment in the BurnLounge scheme.

While the BurnLounge enterprise did have the compensation scheme and revenue generated from the sale of music downloads, income from music sales could never (and in fact never did) fund any substantial portion of the rewards for the Mogul program.

By and large, however, it was the business opportunity and not the products that drove sales of product packages. Less than 1% of the VIP packages were sold to individuals who did not participate in the Mogul Program. the distribution of product packages among the Moguls and non-Moguls indicates that most Moguls would not have purchased the package that they did absent the business opportunity.

While it is true that Retailers could merely sell music downloads through their BurnPages, Retailers/Moguls generated many times more revenue from the sale of the business opportunity to new participants than the meager rewards of vending the music downloads available on the BurnLounge system.

This court finds that ... all of the Defendants ... made misleading affirmative representations regarding actual and potential income ...

The BurnLounge Personal Use Final Order Language is Inconsistent with the FTC's Own Position on Personal Use.

In 2004, the FTC, in a FTC Staff Advisory Opinion and Pyramid Schemes Analysis, responded to an inquiry from the Direct Selling Association, intending to clarify that the FTC did not view "personal use" as the primary determinant of illegality, but rather whether purchases of goods and services were "merely incidental" to "buying in" to the opportunity. In fact, all of its cases have focused on this point.

In its 2004 "clarification letter," the FTC noted:

Internal Consumption

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

It is important to distinguish an illegal pyramid scheme from a legitimate buyers club. A buyers club confers the right to purchase goods and services at a discount. If a buyers club is organized as a multi-level reward system, the purchase of goods and services by one's downline could defray the cost of one's own purchases (i.e., the greater the downline purchases, the greater the volume discounts that the club receives from its suppliers, the greater the discount that can be apportioned to participants through the multi-level system). The purchase of goods and services within such a system can, therefore, be distinguished from a pyramid scheme on two grounds. First, purchases by the club's members can actually reduce costs for everyone (the goal of the club in the first place). Second, the purchase of goods and services is not merely incidental to the right to participate in a money-making venture, but rather the very reason participants join the program. Therefore, the plan does not simply transfer money from winners to losers, leaving the majority of participants with financial losses.

FTC Consent Orders and Final Orders: Why the Overreach?

And so, why the overreaching and unnecessary language on "personal use" that finds its way into the final orders of FTC cases? The FTC noted, in the clarification 2004 letter, that it did not mean such language to be applicable to the direct selling industry in general, but rather to specific egregious pyramid schemes. And, although understanding that such overreaching might place a cloud of uncertainty over mainstream companies, the FTC indicated that it consciously promoted such overreaching language to give it more enforcement flexibility in future prosecutions.

Said the FTC:

With regard to your second question, the Federal Trade Commission often enters into consent orders with individuals and companies that the Commission has determined have violated the FTC Act. To protect the public from those who have demonstrated an unwillingness to follow the law, these orders often contain provisions that place extra constraints upon a wrongdoer that do not apply to the general public. These "fencing-in" provisions only apply to the defendant signing the order and anyone with whom the defendant is acting in concert. They do not represent the general state of the law.

For example, when the Commission brings a pyramid scheme action, the case often concludes with a consent order. The scope and severity of the order will depend upon the facts of the case; however, most such orders contain definitions that exclude any sale to a participant in the

business from the calculation of the venture's legitimacy. These definitions draw very clear lines for those who have demonstrated a willingness to violate the law, but are not intended to represent the state of the law for the general public.

There are Good Historical Guidelines for Recognizing Personal Use.

The issue of recognizing personal use is not new. As far back as 1986, the State of California entered into a Stipulated Order with Herbalife that provides good direction on this subject. The Stipulated Order provided:

5(c). The term "retail sale" as used in this Section 5 means a sale at defendants' product(s) in any of the following situations: (1) to persons who are not part of defendant's marketing program or distribution system; or, (2) to persons who are not buying to become part of defendants marketing program or distribution system; or, (3) to persons who, although desirous of becoming or who are a part of defendants' marketing plan or distribution system are buying for their own personal or family use.

In the aftermath of uncertainty created by FTC actions and class actions, many states, including Louisiana, Texas, Oklahoma, Montana, Idaho, Utah, Washington, South Dakota and Kentucky (with more states considering such amendments) sought to clarify the issue, amending pyramid and MLM statutes to recognize personal use in reasonable amounts:

A typical provision of such legislation from the state of Washington:

'Compensation' means payment, regardless of how it is characterized, of money, financial benefit, or thing of value. 'Compensation' does not include payment based on the sale of goods or services to anyone who is purchasing the goods or services for actual use or consumption.

In fact, legal uncertainty, created by FTC positions and court cases, on the "personal use" issue, prompted, in 2003, the introduction of HR1220 (it did not go forward) to clarify legitimacy of "personal use" and the following proposed language:

5(a)(11) PYRAMID PROMOTIONAL SCHEME- The term `pyramid promotional scheme' means any 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 sales of goods, services, or intangible property to participants or by participants to others.

All of which prompts the suggested action of the above mini-primer:

9. In 2003, the industry introduced proposed federal clarification legislation, HR 1220 to recognize personal use and remove the disconnect and uncertainty; the industry, specifically the DSA, should again initiate such proposed federal legislation.
10. In the alternative, the FTC and DSA, with permission of the BurnLounge defendants, should seek to amend the BurnLounge Final Order to recognize that "sales to the ultimate consumer" include distributor purchases in reasonable amounts for personal use.

And a great place to start would be the crafted language from the 1986 Herbalife case:

The term "retail sale".... means a sale at defendants' product(s) in any of the following situations: (1) to persons who are not part of defendant's marketing program or distribution system; or, (2) to persons who are not buying to become part of defendants marketing program or distribution system; or, (3) to persons who, although desirous of becoming or who are a part of defendants' marketing plan or distribution system are buying for their own personal or family use.

Or language from one of many state statutes:

'Compensation' means payment, regardless of how it is characterized, of money, financial benefit, or thing of value. 'Compensation' does not include payment based on the sale of goods or services to anyone who is purchasing the goods or services for actual use or consumption.

Finally, it is submitted that the following model pyramid language, relating to personal use, might serve as a synthesis of trending state legislation, FTC staff advisory and reasoning set forth in various federal and state court opinions:

*Prohibited Marketing Scheme means an illegal pyramid sales scheme, ... Ponzi scheme, chain marketing scheme, or other marketing plan or program in which participants pay money or valuable consideration in return for which they obtain the right to receive rewards for recruiting other participants into the program, and those rewards are unrelated to the sale of products or services to ultimate users. Prohibited payment or consideration does not include payment for non-commissionable "not for profit" or "at cost" sales and marketing materials support. **For purposes of this definition, "sale of products or services to ultimate users" include sales to participants, in reasonable amounts, for actual personal or family use.***

In Summary:

In the end, all parties will be better off by eliminating the disconnect that seems to create lines of cases that rightly condemn egregious pyramid practices, but inadvertently, in their final orders, sweep into the "pyramid net" practices of legitimate direct selling companies whose distributors may also be ultimate users of products and services, who purchase for actual use

and consumption and not for incidental reasons of merely qualifying for rewards in a pyramid scheme.

It is expected that companies and their compliance departments will develop their own unique approaches to dealing with FTC v. BurnLounge and the ongoing line of cases, legislation and regulation that impact "personal use." **Tune in to www.mlmllegal.com for ongoing updates and analysis.**

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