A. The association members were polled by us and asked by us if they were interested in having us supply certain products.

Q. "Us," meaning yourself, Mr. DeVos?

A. By "us" I should say, Amway Corporation, Mr. DeVos and myself and the company that we built behind that.

Two of the 35 former Nutrilite distributors who became Amway distributors were called as witnesses. Walter Bass, the first president of the ADA, acknowledged that Mr. Van Andel and Mr. DeVos created Amway. He was asked about the formation of Amway and the ADA. (Bass, Tr. 70–71):

Q. Were Richard DeVos and J. Andel [sic] some of the key people involved?

A. They were the key people.

Q. They were more key than any other persons, that is what you are saying?

A. It was their idea.

Q. Were they doing business under the name Ja-Ri Corporation?

A. Yes.

Q. For what reason, if you know, did these key people, yourself included, get together to form this association?

A. We foresaw some problems in the Nutra-Lite organization that alarmed us and rather than to allow is [sic] to just go out of existence, the idea of Amway was developed.

[80] Mr. Bass could name only 6 of the 35 Nutrilite distributors who allegedly started Amway. (Bass, Tr. 68–69) Bernice Hansen, also one of the 35 Nutrilite distributors who became Amway distributors, was called. She too identified Mr. Van Andel and Mr. DeVos as the persons who "started Amway." (Hansen, Tr. 3301–02)

The impetus for the restrictions imposed on distributors in this case clearly came from above. Mr. Van Andel and Mr. DeVos started Amway, not the 35 Nutrilite distributors. Mr. Van Andel and Mr. DeVos used the association of distributors to communicate and control the distribution of the products they were to make, but the thrust to build the Amway organization as it now stands came from those two individuals, not from a committee. (Findings 19–25)

Here the dealers do not control the manufacturer, as in *United States* v. *Topco Assoc., Inc.*, 405 U.S. 596 (1972) and *United States* v. *Sealy, Inc.*, 388 U.S. 350 (1967). Nor did the dealers here prevail upon the manufacturer to impose the restrictions. *United States* v. *General Motors Corp.*, 384 U.S. 127 (1966). Mr. Van Andel and Mr.

DeVos initiated and orchestrated the scheme, and notwithstanding the willing participation of the distributors, Amway is the dominant partner. *Newberry* v. *Washington Post Co.*, 438 F. Supp. 470, 474 n.5 (1977).

When Amway was created, Mr. Van Andel and Mr. DeVos, through the Ja-Ri Corporation, were distributors as well as manufacturers. (CX 53–J) But in replacing the previous suppliers in the Nutrilite organization, and adopting the distribution system from that organization, they were acting essentially alone.[9] The restraints are not, therefore, "primarily 'horizontal.' " *The Coca-Cola Company*, Dkt. 8855, Commission Opinion p. 8 (Decided April 7, 1978). [81] "[O]nly by ignoring the essential relationships which exist" between Amway and the distributors might it be concluded that the restraints are horizontal. (*Ibid.*)

Horizontal Cooperation by ADA

Complaint counsel argue that respondents are engaged in an unlawful group boycott because the ADA is the "final arbiter of disputes and interpretations of the Code of Ethics and Rules of Conduct." (CB, p. 5)

The Amway Distributors Association of the United States is a voluntary association of independent Amway distributors. (Findings 11–12) Voting membership in this trade association is open to qualified Direct Distributors. (Finding 13) Voting members may attend annual meetings to receive reports concerning Amway and elect ADA Board members. (Finding 76)

The ADA Board meets four times a year. Amway seeks advice from the ADA Board concerning any changes in Amway rules. (Finding 78) Rather than an agreement among equals, this aspect of the ADA is a means by which Amway controls the distribution of its products through independent salespersons by convincing them—not coercing them—to accept changes in the Amway Sales and Marketing Plan. Mr. Halliday testified that (Tr. 6612–13): [82]

> As a matter of policy, Amway Corporation presents the proposals for changes of rules to the board for educational purposes, instructional purposes, for feedback from the board as representative of the distributor organization as to the kind of reaction to the change, as to the timeliness of implementing the rule changes; it is an opportunity to sell the board so that they and their distributors in their organizations wil enthusiastically support the notion of moving ahead in that direction. Again, we ar talking about a group of volunteers.

[9] There is some evidence that one of the distributors suggested to Mr. Van Andel and Mr. DeVos that t product "Frisk" be distributed. (Halliday, Tr. 6541) The preponderance of the evidence, however, supports t finding that the genesis of Amway was vertically imposed. *Cf. Sandura Company* v. *FTC*, 339 F.2d 847, 857–58 (Cir. 1964).

> You just don't say tomorrow we are going to propose a new rule and bang this is the rule, or tomorrow we are going to change a rule and bang this is the rule. What we try to do is to present it to the board and the distributor organization [so] that when the date of implementation occurs, which we determine, that it is accepted with full enthusiasm and that people move ahead voluntarily, then, to act in accordance with those changes.

The ADA Board of Directors also acts as an arbitration panel for disputes in which Amway decides to discipline a distributor for a rule violation. If Amway decides not to impose sanctions for a violation of a rule, the ADA has no authority to recommend the sanction. (Van Andel, Tr. 1838–39) If Amway does impose a sanction, the distributor may bring the matter before the ADA Board. (Finding 80) Amway has bound itself by the decision of the Board on these arbitration cases. (Halliday, Tr. 6180)

Group boycotts are *per se* unlawful. In *Fashion Originators' Guild* v. *FTC*, 312 U.S. 457 (1941), a group of "original designers" agreed to refuse to sell their creations to retailers who had been selling copies of original designs. [83] The purpose of the agreement was to prevent style piracy, and the Court held that it was an unlawful group boycott and upheld the Commission's refusal to hear evidence on the reasonableness of the methods pursued by the combination. The issue involving the ADA, then, is whether the self-regulation is an unlawful group boycott like the *Fashion Originators'* case or whether it is pro-competitive.

Self-regulation by an industry has been allowed by the courts where:

(1) There is a legislative mandate for self-regulation. *Gordon* v. *New York Stock Exchange*, 422 U.S. 659 (1975).

(2) The collective action

> (a) is intended to accomplish an end consistent with the policy justifying self-regulation
> (b) is reasonably related to that goal, and
> (c) is no more extensive than necessary.

enver Rockets v. *All-Pro Management, Inc.*, 325 F. Supp. 1049, 1064 .D. Cal. 1971).

The association provides procedural safeguards which assure that restraints are not arbitrary and which furnish a basis for judicial iew. *McCreery Angus Farms* v. *American Angus Ass'n.* 379 F. p. 1008, 1018 (S.D. Ill. 1974), *aff'd*, 506 F.2d 1404 (7th Cir.); *'ani* v. *NYSE*, 348 F. Supp. 1185 (S.D.N.Y. 1972).

The main purpose of the self-regulation by the respondents meets this test. (Findings 22, 78 and 80) [84]

"In an industry which necessarily requires some interdependence and cooperation, the *per se* rule should not be applied indiscriminately." *Hatley* v. *American Quarter Horse Ass'n,* 552 F.2d 646, 652 (5th Cir. 1977). In the direct selling of soap and detergents, "a few rules are essential to survivial." (*Ibid.*) Participation by the ADA as an arbitration panel does not by itself, without consideration of the specific rules involved, amount to a naked restraint of trade. An analysis of each rule alleged to violate the law is necessary to understand fully whether it is anticompetitive.

Discontinuance and Remote Evidence

Respondents argue generally that a substantial number of the exhibits relied on by complaint counsel are dated six years or more before the issuance of the complaint, and specifically that the customer protection rule, alleged to be evidence of retail price fixing, was dropped by Amway at the beginning of 1972.

Respondents rely primarily on *New Standard Pub. Co.* v. *FTC,* 194 F.2d 181 (4th Cir. 1952). In that case, the Commission issued an order six years after the last evidence was taken and the circuit court reversed and remanded. The court did not hold that the case was moot, but sent it back for more recent evidence. Respondents also rely on *Oregon-Washington Plywood Co.* v. *FTC,* 194 F.2d 48 (9th Cir. 1952). That case involved two groups which allegedly conspired to commit trade restraints. The respondents admitted the restraints had occurred up until seven years before the complaint issued and denied any further violation after that time. Complaint counsel did not put on any evidence, and the Commission issued an order based on the pleadings, relying upon a rule that a conspiracy once shown to exist is presumed to continue until abandonment is shown. The circuit court reversed, holding that the answers to the complaint denying the conspiracy put the matter in issue [85] and since complaint counsel did not put on any evidence and there was no such presumption, the complaint should have been dismissed. The court also held that there was nothing to show that the discontinuec practices would be resumed and that discontinued practices do no provide a basis for an order.

The two issues here involve (1) the alleged discontinuance as defense, and (2) the age of the evidence.

The case law is clear that discontinuance of an illegal practice do not of itself render inappropriate the entry of a cease and des order. *Oregon-Washington Plywood Co.* v. *FTC,* 194 F.2d at 50–

The propriety of such an order in any particular case must depend on a consideration of all the surrounding facts and circumstances; and where the activities charged have been discontinued, the elements of time, volition and general attitude of the respondents in respect of the cessation are necessarily factors of prime importance. Parties who have abandoned their challenged practices only after proceedings are brought against them are in no position to complain of a cease and desist order. In such a case the discontinuance can hardly be thought voluntary.

And the cases have clearly held that discontinuance after the investigation has begun will not be held voluntary. *Giant Food, Inc.* v. *FTC*, 322 F.2d 977, 986-87 (D.C. Cir. 1963); *Cotherman* v. *FTC*, 417 F.2d 587, 594-95 (5th Cir. 1969); *Coro, Inc.* v. *FTC*, 338 F.2d 149, 153 (1st Cir. 1964), *cert. denied*, 380 U.S. 954 (1965). Here, Amway officially discontinued the customer protection rule in 1972 (although Amway has continued to urge distributors that such competition is "unethical"). (Findings 90-93) [86] Mr. DeVos told Direct Distributors in Dallas in 1971 the reason that the customer protection rule was goind to have to go (DeVos, CX 1037-E):

And I must be very frank with you—I think that the rule will have to go and it'll have to go probably in the not too far distant future. And the reason it'll have to go is that I don't think we can live with it any longer, I don't think we are consistent in our philosophy and I don't think the governmental people are gonna look at it favorably. They've already looked at it and they say that's a restraint of trade type thing, you see.[10]

The record shows that Amway knew of the Federal Trade Commission investigation in this case before January of 1970. (CX 345-E) The discontinuance of the customer protection rule by Amway was not the kind of abandonment of an illegal practice which gives assurance that it will not be repeated in the future. *Holiday Magic, Inc.*, 84 F.T.C. 748, 1050 (1974).

Some of the evidence relating to price fixing and customer estraints in this case goes back to the 1960's. Such evidence is elevant to show a continuing effort to fix prices and restrain mpetition. See *FTC* v. *Cement Institute*, 333 U.S. 683, 703-05 (1948), nere the Court held that the Commission had properly regarded idence as far back as 1902 in the price fixing case. And in *P.F. llier & Son Corp.* v. *FTC*, 427 F.2d 261, 275 (6th Cir. 1970) the pondent had argued that the evidence was cold and stale, but the rt upheld the Commission's order, stating that the fact that the ence may be old does not mean that an order issued upon it is ited. The court held that where an illegal trade practice is ble of being perpetuated or resumed, it may be presumed to

opping a practice after a visit by government investigators does not show permanent abandonment. *United Parke, Davis & Co.*, 362 U.S. 29, 47-48 (1960).

have been continued, [87] and an order may issue to prevent it, even upon a showing that it has been discontinued or abandoned.[11] Here, Amway had an explicit policy of retail price fixing in the middle 1960's, and, until 1972, a written policy of preventing distributors from competing with each other. This evidence raised a presumption that these policies have continued or could be resumed.

Count I—Price Fixing

The Rules of Conduct of the Amway Sales Plan published in 1963 required that distributors sell Amway products to consumers at the specified resale price. (Finding 109) It also provided that no unauthorized discount be given on sales to other distributors, and fixed the resale charge for freight. (Finding 109-111) The record does not show when Amway stopped using this sales manual or whether distributors were ever clearly notified that it does not express Amway's policy.[12] Such resale price maintenance is *per se* unlawful. *Dr. Miles Medical Co.* v. *John D. Park & Sons Co.*, 220 U.S. 373 (1911). [88]

The Career Manual for Amway distributors published in 1968 specified that distributors should not cut the retail price in fund-raising drives. The fund-raising drive policy was changed in 1969, upon the recommendation of the ADA, so that the retail sales now are made by the distributor rather than by the fund-raising organization. (Finding 112) By implication at least, this change was made with the intent to control resale prices. While the policy requiring the distributor rather than the fund-raising organization to make the retail sales might be reasonable in itself, when coupled with unlawful intent it became an unreasonable restraint of trade. *United States* v. *Columbia Steel Co.*, 334 U.S. 495, 522 (1948).

While much of the evidence of price fixing agreements is relatively old, it raises a presumption of continuity which respondents have not rebutted.[13] After express contracts were no longer used, the othe vertical restraints on advertising, selection of customers and sourc of supply controlled price competition. The customer protection ru alone stopped all competition for a retail customer for 30 days after distributor made a sale to that customer. (Finding 90) The purpose

[11] The court in *P.F. Collier* specifically declined to follow *Bearings, Inc.*, 64 F.T.C. 373 (1964), relied (respondents. 427 F.2d at 275 n.13.

[12] On retail sales, Amway's price lists obliquely refer to "suggested retail for sales tax" or "retail sal computation base." (Finding 113) The record does not show that Amway has ever clearly told its distributo they are free to set their own prices on sales to other distributors or to consumers.

[13] *Holiday Magic, Inc.*, 84 F.T.C. 748, 1050 (1974). Amway was able to produce distributors who do us competitively to obtain wholesale and retail sales. (RPF 223-229) Considering the number of distributors Amway products, this is not surprising. Furthermore, evidence of price competition conflicts with state Amway officers who say that very little price cutting occurs. (Finding 127)

the customer protection role was "to prevent cut throat competition" between distributors. (Halliday, CX 486)[14] [89] Amway officially discontinued the rule only after Federal Trade Commission investigators looked at it and said it was a restraint of trade. (DeVos, CX 1037-E) Amway continues to support the principle of the customer protection rule by calling such competition "unethical." (Finding 93) One of the distributors testified to the effect of the customer protection rule in her organization. Mrs. Joan Spradley was asked by some of the distributors in her group if they could discount retail prices. She said "no." Mrs. Spradley testified that (Tr. 1340):

> It was our understanding that the retail price was a set thing, and that we did not compete with one another for customers. In other words, we understood when a Amway distributor made a contact, for instance, if I came to you and sold you Amway products, then you became my customer and under our ethics, another Amway distributor would not go and try to sell to you or undercut my price or anything like that. I would sell to you at the retail price and they would leave you alone and go get their own customers.

The customer protection rule has been used to support and continue the unlawful price fixing found herein and must be prohibited. "A practice which lessens price competition touches the core of the free enterprise system." *The Coca-Cola Company, et al.*, FTC Dkt. 8855 (Final Order dated April 7, 1978), at p. 89.

Amway threatens to terminate the distributorship of distributors who cut the retail price of Amway products. (Findings, 115, 117, 119) And where the price cutting distributor is not buying directly from Amway, the threat is made in combination with Direct Distributors. (Findings 115-117) Amway also encourages Direct Distributors to do a "sales job" on price cutting distributors, pointing out the reck-'essness of this conduct (Finding 115), and Amway urges that this hould be done through a combination of Direct Distributors. ᶠinding 116) [90]

Amway distributors promote the policy of discouraging price tting through their combined efforts with Amway. Price cutters ᵌ quickly reproached by other distributors, and it is not long until ıway applies pressure directly and through Direct Distributors to ı the "disturbance in the field." (Findings 117, 121) Many Amway :ributors are inexperienced in business (Van Andel, Tr. 1814-15) it does not take much pressure to stop price cutting. They :ly comply with the demands of Amway and other distributors ıp cutting retail prices. (Finding 117) *Holiday Magic, Inc.*, 84 748, 1049 (1974). While only a few distributors were actually

\mway market study in 1970 warned that lifting the customer protection rule could lead to "excessive g" by distributors. (CX 522-Z-215) coerced on this record (Findings 117, 121), price fixing agreements are unlawful *per se* regardless of enforcement. *Holiday Magic, Inc.*, 84 F.T.C. 748, 1049 (1974). And where the unlawful intent to fix prices is coupled with a single instance of coercion, even the Sherman Act will be violated. *Newberry* v. *Washington Post Co.*, 438 F. Supp. 470, 480–82, 485 (D.D.C. 1977). Here, the action by Amway in combination with Direct Distributors and other distributors to achieve uniform prices for Amway products would probably violate the Sherman Act, *United States* v. *Parke, Davis & Co.*, 362 U.S. 29, 45–46 (1960), and clearly violates Section 5 of the Federal Trade Commission Act which was intended by Congress to stop such conduct before it amounts to "full blown" violations of the Sherman Act. *FTC* v. *Brown Shoe Co.*, 384 U.S. 316, 320–22 (1966)

Amway quickly admonishes distributors who advertise Amway products at discount prices. (Findings 117, 119, 121) For example, Roger Laverty, an Amway distributor from Pompano Beach, Florida, had prepared sales literature using the Amway trademark, featuring price comparisons on Amway and competing products. An Amway Administrative Legal Assistant wrote to Laverty stating Amway's view of the law (CX 989–B): "[C]ost comparisons themselves are now strictly 'taboo,' are not used by Amway and should not be used by Amway distributors." On the contrary, however, the law protects price competition by truthful advertising. See *Sunbeam Corp.* v. *Payless Drug Stores*, 113 F. Supp. 31, 44 (N.D. Cal. 1953), citing *Prestonettes, Inc.* v. *Coty*, 264 U.S., 359, 368 (1924) (Mr. Justice Holmes): **[91]**

> A trade mark only gives the right to prohibit the use of it so far as to protect the owner's good will against the sale of another's product as his. . . . When the mark is used in a way that does not deceive the public we see no such sanctity in the word as to prevent its being used to tell the truth. It is not taboo.

Amway completes its control of retail prices by extending the bu back rule beyond its legitimate purpose—to prevent invento loading. Amway urges its distributors not to allow freight damag Amway products to reach the hands of salvage stores or if they dc buy them up before consumers can get to them. (Findings 122,]

According to the Amway Career Manual published in 1968, Board of Directors of the association "meets at least three tim year to act on approval of product classifications for distrib under the Amway name, sales policies, pricing policies, discoun refund schedules . . . ." (CX 59–J) The record does not shov this policy has been discontinued. In fact, the ADA has cor with Amway in setting retail prices and has recommended changes and agreed with Amway on retail pricing policy. (Findings 79, 112(b))

Generally, a manufacturer who sells through independent wholesalers and retailers would prefer the lowest retail price possible, since that usually means increased sales and higher manufacturer revenues. *Continental T. V., Inc.* v. *GTC Sylvania, Inc.*, 433 U.S. 36, 56 n.24 (1977). Here, however, Amway's self-interest in preventing price cutting was indicated by Mr. Van Andel who reported in 1970 that a market test of Amway catalog products proved that the same products sold for a higher price led to 50% more sales, since the direct selling [92] distributors worked harder to obtain the higher margin. (CX 638-H) Since the higher price encourages distributors to do more selling, Amway does not sponsor special sales by granting extra discounts, and Amway sets the retail price of its catalog goods "competitive with the average department store level—without the specials." (*Ibid.*)[15]

The number of reports of distributors cutting the retail price of Amway products usually is something less than a dozen. (Halliday, CX 1040-H; DeVos, CX 1037-D). The "methods" employed by Amway and its distributors are "as effective as agreements in producing the result that 'all who would deal in the company's products are constrained to sell at the suggested prices.' " *United States* v. *Parke, Davis & Co.*, 362 U.S. 29, 42 (1960) (quoting *FTC* v. *Beech-Nut Packing Co.*, 257 U.S. 441, 455 (1922).

Empirical studies show that resale price maintenance does raise etail prices above what they would otherwise be. *Hearings on S.408 ?fore the Subcommittee on Antitrust and Monopoly of the Senate udiciary Committee*, 94th Cong., 1st Sess., p. 174 (1975). Such evidence l Congress to repeal the Miller-Tydings and McGuire Acts, which ·mitted states to enact "fair trade" laws authorizing sellers to iblish resale prices for branded commodities. 15 U.S.C. 1, 45 ective March 11, 1976). "Price is the 'central nervous [93] system of conomy.' " *Nat'l. Soc. of Prof. Engineers* v. *United States*, 435 U.S. 1978-1 Trade Cases ¶61,990 at 74,225 (decided April 25, 1978). ndents regularly treat the subject of resale prices, however, in a er and informal manner.[16] "Price is too critical, too sensitive a

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68, an Amway employee reported that retail prices on Amway products "are in most instances higher than comparable items in conventional retail outlets." (CX 558-B) Customer complaints about t prices (CX 700-J) may have changed Amway's pricing policy. In 1970, retail prices set for most og products were set below the prices for comparable items sold in department stores but above prices scount stores. (CX 522-Z-176 to 177)

Vos' advice to Direct Distributors on how to handle price cutting distributors exhibits a lack of nsistent with the sensitive nature of the subject. He incoherently mixes warnings of price fixings erminate the distributor or to badger, threaten and otherwise "do a sales job on the guy" because l against anything that's dog eat dog." (CX 1037-E to I) control to allow it to be used even in an informal manner to restrain competition." *United States* v. *Container Corp. of America*, 393 U.S. 333, 338 (1969). [94]

Counts II and III of the Complaint

Count II of the complaint alleges that respondents unlawfully allocate the Amway distributors' customers and source of supply. This allegation deals primarily with two rules of the Amway Sales and Marketing Plan: (1) the retail store rule requiring distributors not to allow Amway products to be sold through retail stores (Finding 85), and (2) the cross-group selling rule requiring distributors to sell Amway products only to distributors they have recruited and to buy Amway products only from their sponsor. (Finding 81)[17]

Count III of the complaint alleges that Amway restricts the advertising and promotional activities of the distributors. This allegation deals with the detailed regulation of its distributors' advertising. (Findings 94–108)

These rules are vertical in nature. Vertical customer allocations and requirements contracts are not the kind of "agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." *Northern Pac. R. Co.* v. *United States*, 356 U.S. 1, 5 (1958). The vertical restrictions here must be analyzed under the rule of reason. *Continental T. V., Inc.* v. *GTE Sylvania, Inc.*, 537 F.2d 980 (9th Cir. 1976), *aff'd*, 433 U.S. 36 (1977). [95] The *Sylvania* case involved location restrictions imposed on dealers by a small manufacturer competing in an oligopolistic market. 537 F.2d at 1001. The Court held that some vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain marketing efficiencies in the distribution of its products. Among these "redeeming virtues," the Court found that established manufacturers may us[e] them to induce retailers to provide services necessary to the efficier[nt] marketing of the products and that new manufacturers may u[se] them to induce competent and aggressive retailers to do the wo[rk] necessary to distribute products unknown to consumers. 433 U.S. [at] p. 55. The Court overruled the vertical *per se* rule stated in *Uni[ted] States* v. *Arnold, Schwinn & Co.*, 388 U.S. 365 (1967) and, while foreclosing the possibility that particular applications of ver[tical] restrictions might justify *per se* prohibitions, the Court clearly that departure from the rule of reason standard must be based

[17] The customer protection rule has been considered a part of the unlawful price fixing combination, : 88–89.

demonstrable economic effect rather than—as in *Schwinn*—upon formalistic line drawing. 433 U.S. at 59. No such economic effect has been proved here and the restrictions should not be treated under the *per se* rule.

Complaint counsel argue that: "Restrictions such as these should not be individually analyzed, for they work their toll on competition collectively." (CRB, p. 37) Nothing in the record compels the conclusion, however, that the restrictive provisions were employed in combination in an effort to eliminate or restrain competition to the detriment of consumers. *Snap-On-Tools Corp.* v. *FTC,* 321 F.2d 825, 830 (7th Cir. 1963):

> Except for the fact that the provisions are all found in one document, there is no evidence, let alone substantial, to show that these provisions were designed to be, or were employed as a *unitary device* to foster practices violative of Section 5 of the Act. (Emphasis by court.)

[96] Each restraint therefore must be analyzed individually to determine whether the preponderence of the evidence shows the prohibited purpose or effect.

The Amway Sales and Marketing Plan has involved wholesale and retail price fixing. If other restrictive practices were "ancillary" to this price fixing, or "part of a scheme involving price fixing," the result would be a *per se* violation of law. *United States* v. *Arnold, Schwinn & Co.,* 388 U.S. 365, 373 (1967); *White Motor Co.* v. *United States,* 372 U.S. 253, 260 (1963).[18] Here, however, no such finding can be made on this record. Here, the price fixing is ancillary and incidental to the other vertical restraints, to which respondents have spent most of their efforts. The other vertical restraints should therefore be judged independently from the price fixing. *United States* v. *Sealy, Inc.,* 388 U.S. 350, 351–52 (1967); *United States* v. *Arnold, Schwinn & Co.,* 388 U.S. 365, 373 (1967); *White Motor Co.* v. *United States,* 372 U.S. 253, 260, 263 (1963). [97]

Applying the rule of reason standard to vertically imposed ritorial restraints, the Commission in *The Coca-Cola Company, et* FTC Dkt. 8855 (Final Order dated April 7, 1978) [91 F.T.C. 517], d that the vertical restraints involving nonrefillable bottles were roader scope than reasonably necessary[19] to achieve marketing

ı those cases, price fixing allegations in the complaints "accompanied" the allegations of other vertical ts, but the Court did not rely on that fact in deciding whether the *per se* rule should be used. The test is not price fixing allegations "accompany" allegations of other vertical restraints but whether the main and effect of all of the vertical restraints show a justifiable business reason, or whether they are mainly t fixing prices for which there is no acceptable economic basis. *(Ibid.)* The Commission referred to, but did p, this issue in the letter explaining the acceptance of a consent order in *Performance Sailcraft Inc.*, File . 2922] (Commission action dated May 2, 1978) [91 F.T.C. 869].

e the courts have split on adopting this part of the ancillary restraints doctrine (see dissenting opinion ioner Clanton in *Cola-Cola, supra,* at pp. 11–12), it was relied on in part of *Schwinn,* not reversed by

(Continued)

efficiencies by inducing capital investment, local advertising and promotional and service activities by the supplier's customers; and that intrabrand competition would be likely to invigorate price competition. The restrictions as to sales of the soft drinks in refillable bottles were, however, held reasonable because of practical marketing difficulties and consumer benefits associated with that product.

On this record, Amway's cross-group and retail store rules and its regulation of advertising, are reasonable and have provided entry to a marketplace[20] which would not otherwise have been available. (Dunlap, Tr. 6676–77) While this defense may not be a "perpetual license to operate in restraint of trade," *Siegel* v. *Chicken Delight, Inc.*, 448 F.2d 43, 51 (9th Cir. 1971), respondents' control of the distributors' marketing practices is no broader than necessary to achieve the main purpose of direct selling in an oligopolistic market.[21] [98] Furthermore, the restrictions here are not an "industrywide practice"[22] involving a "dominant brand" by an "established giant in the industry." (*Coca-Cola Co.*, *supra*, at pp. 35, 47 and 51)

The Retail Store Rule

The Amway Sales and Marketing Plan requires that Amway products be sold directly to consumers and not through retail stores.[23] (Finding 85) Based upon evidence adduced through expert witnesses, Amway executives and numerous Amway distributors, it is apparent that the rule has preserved Amway's direct selling organization and consumer demand, and provided an incentive to distributors to furnish services to consumers.

Marketing experts gave credible testimony in this proceeding that if Amway products were sold in retail stores, distributors would lose interest in calling on consumers' homes, demonstrating and explaining products to create a demand which could be satisfied —perhaps at a lower price— at a retail store. (Finding 89) Without a demand for the products, retail stores would soon lose interest in Amway

Sylvania. The Court held that where Schwinn retained indicia of ownership it could, under the rule of reason, confine sales to franchised retailers for the reason, *inter alia*, that the restraint "was justified by, and *went no further* than required by, competitive pressures." 388 U.S. at 382. (Emphasis added.)

[20] While Amway sells a variety of products, its main business is still "selling soap." (RX 331, p. 4–A)

[21] Unlike some other direct selling companies, Amway does not prohibit distributors from selling competing products. (RX 331, p. 15–B; Bortnem - W.T. Raleigh, Tr. 697–99; Cooke - Avon Lady, Tr. 735–36; Laverty - Fuller Brush, W.T. Raleigh, Tr. 838–39). And, unlike Avon, the largest direct selling company, Amway does not assign sales territories to its distributors. (Cooke - Avon, Tr. 735; Halliday, Tr. 6192–93)

[22] Direct selling companies generally do not, however, sell their products through retail stores. (Patty, Tr. 3099–3103)

[23] Amway also prohibits distributors from selling or displaying Amway merchandise at flea markets and similar events (Finding 86) and regulates their sales through fund-raising drives. (Finding 87). The rationale for these restrictions is the same as the retail store rule and they have the same economic impact as that rule.

products. Amway would then be faced with the necessity of creating demand in the traditional way of advertising expenditures and [99] otherwise doing battle in the retail grocery stores, in a hostile oligopolistic marketplace. (Findings 171-181) Vertical restrictions on intrabrand competition may be used to allow a company to compete in an oligopolistic market. *Sylvania, supra.*[24]

The retail store rule gives Amway distributors an incentive to provide services to consumers and to create a consumer demand which would dissipate if Amway products were sold in retail stores. Amway distributors demonstrate and explain Amway products and deliver to the consumer's home. These services are typically unavailable from retail stores. (Finding 88) Because some Amway products are more concentrated than products sold in retail stores, demonstration and explanation are essential to consumer demand. (Diassi, Tr. 5529; Schroeder, Tr. 5355-56)

Vertical restraints which induce retailers to engage in promotional activities and to provide services help stir interbrand competition and should be encouraged. *Sylvania, supra; Snap-On Tools, supra,* 321 F.2d at 828-29. The retail store rule is such a vertical restraint and is lawful under the rule of reason. [100]

Cross-Group Selling Rule

The cross-group selling rule requires Amway distributors to buy Amway products only through their sponsor. (Finding 81) The distributors, in effect, promise to buy their "requirements" of Amway products from one supplier. There has been no showing on this record of any probable immediate or future market pre-emption which might substantially lessen competition. *Tampa Electric Co.* v. *Nashville Coal Co.,* 365 U.S. 320, 329 (1961).

The cross-group selling rule also provides that distributors shall sell at wholesale only to their sponsored distributors. This aspect of the rule has the same economic justification as the retail store rule.[25]

The cross-group selling rule is the basis for the Amway Sales and Marketing Plan. It provides the structure by which products, information and compensation flow from Amway to the Direct Distributors and down to the distributors engaged in making the retail sale. It provides lines of communication and responsibility insuring that distributors are properly trained and motivated and that consumers receive services provided under the Amway system

[24] Sylvania's market share was 5%, 433 U.S. 46-47 n.12, almost triple Amway's 1.7% of the soap and detergents market. (RX 406, RX 407)

[25] Amway also restricts distributors from selling non-Amway products to Amway distributors they have not sponsored. (RX 331, p. 15-B) The business reason for this restriction is to prevent a "conflict of interest." (Van Andel, Tr. 1896) The record does not show the market impact, if any, of this provision.

of distribution. (Finding 82) Used in conjunction with the performance bonus system, the cross-group selling rule gives sponsoring distributors an incentive to recruit, train, motivate and supply other distributors in order to gain a reward based on the sponsored distributors' sales volume. If sponsored distributors could buy Amway products from someone other than their sponsor, that incentive would not exist. The cross-group selling rule thus provides an alternative to payment of a "headhunting" fee as an incentive for recruiting. (Patty, Tr. 3111–13) **[101]**

Amway's Market Concept

Amway's marketing image was summarized well by one of respondents' expert witnesses (Diassi, Tr. 5542–43):

> I would think that it is based a great deal on the form of the product, that is, it is a concentrated product for the consumer. It is one that she has to use very little of per washload and therefore economical to use. I think that they have built in one other feeling for it and that is the idea that it is delivered directly to the home. There is a service portion that is built into the, into that product itself.
>
> I think to a certain degree that there is some exclusivity built into it, too, that you can only buy it from an Amway distributor. It is not a product that everyone can get ahold of, although I am sure Amway would like to have everyone buy the product. But I think those are the ingredients that go into it. It is a very high quality sophisticated product that almost requires somebody to tell you how to use it as opposed to something that is in a supermarket that you just go out and kind of dump into the machine.

The concept of which market a company like Amway wants to compete in has been protected by the courts which have upheld rules, more restrictive than those involved here, because they were necessary to maintain that concept. In *Evans* v. *S.S. Kresge Co.,* 544 F.2d 1184 (3d Cir. 1976), *cert. denied,* 433 U.S. 908 (1977), a department store chain licensed the use of the K-Mart service trademark and a "one stop shopping" concept to various independent food stores. The resulting retail outlet was comprised of the independent food store and the chain department store under one roof with one K-Mart sign appearing outside. The department store chain was interested in drawing on customers making frequent food purchases [102] at the grocery stores. In order to retain its reputation and market concept for high volume and low prices, Kresge required the grocery stores, *inter alia,* to agree to set prices on their non-food items (2%–5% of their volume) at prices no higher than the prices charged by the department store for the same items. The Third Circuit Court of Appeals upheld the summary judgment for Kresge, holding that there was no violation of the Sherman Act (544 F.2d at 1193):

> . . .[T]he challenged restraint enabled Kresge to add a food component to its discount operation without causing customer confusion or threatening the low-price "K-Mart" discounting image upon which the success of K-Mart (including K-Mart Food) would depend. Therefore, far from attempting to stifle competition, the restraints had as their purpose the stimulation of business and efficiency for both the department store and the supermarket: they (the restraints) would assure that the overall operation would compete effectively in both the discount and food markets vis-a-vis other department store and food discounters. The restraints thus serve a legitimate business purpose.

The trademark licensor's market concept was also upheld in *Weight Watchers of the Rocky Mountain Region, Inc.* v. *Weight Watchers Int'l, Inc.*, 1976-2 Trade Cas. §61, 157 (E.D.N.Y. 1976). There, Weight Watchers International had licensed its trademarks and system of weight control to over 100 independent franchisees. The franchise agreement prohibited the franchise from offering "front loading" or "prepayment" plans whereby the members were asked to prepay their fees for weight control classes to be held in the future in return for which they received discounts and some meetings without charge. Weight Watchers International prohibited prepayment plans because other weight loss clubs had engaged in fraudulent practices in connection with such arrangements. The plaintiff franchisee [103] nevertheless required prepayment, arguing that it put pressure on members to attend weight classes. Weight Watchers International argued that its marketing concept was that no commitment by the member was central to its weight plan. The court held that the rule was consistent with the antitrust laws and that the franchisee had interfered with the defendant's central marketing concept (at p. 70, 226): "[Weight Watchers International's] limitation on price policy is . . . an integral part of its method. Any modification of it might do serious damage to the good will of International."

The market concept by which Amway has, in less than 20 years, successfully added a new competitive presence to the oligopolistic soap and detergents market, among others, depends on the vertical restraints imposed on the distributors such as the retail store rule and the cross-group selling rule. Any modification of these rules might well do serious damage to this marketing concept and Amway's goodwill.

Trademark and Servicemark Protection

Amway argues that it has established several rules, including the retail store rule and those regulating distributors' advertising, in order to protect its goodwill and trademarks and servicemarks.

The owner of a mark must prevent third parties from misusing a mark or will be deemed to have abandoned it. *Dawn Donut Co.* v. *Hart's Food Stores, Inc.*, 267 F.2d 358, 366 (2d Cir. 1959).[26] **[104]** This means that a trademark owner has the right to supervise to some extent the quality of goods and services offered by licensees under that mark. *Siegel* v. *Chicken Delight, Inc.*, 448 F.2d 43, 51 (9th Cir. 1971), *cert. denied*, 405 U.S. 43; *Denison Mattress Factory* v. *Spring-Air Co.*, 308 F.2d 403, 409 (5th Cir. 1962). It does not mean, however, that merely because restrictive provisions are part of a trademark licensing arrangement those provisions are immunized from the antitrust laws, where their central purpose is to restrain trade. *Timkin Roller Bearing Co.* v. *United States*, 341 U.S. 593, 598–99 (1951). Specifically, a manufacturer cannot maintain resale prices under the theory that discount prices will interfere with trademark rights. *Sunbeam Corp.* v. *Payless Drug Stores*, 113 F. Supp. 31, 44 (N.D. Cal. 1953). Protection of the goodwill embodied in a trademark may, however, justify an otherwise invalid trade restraint such as a tying arrangement. *Susser* v. *Carvel Corp.*, 332 F.2d 505, 512 (2d Cir. 1964). And the worth of the trademark will be assessed in determining the reasonableness of requirements contracts, *Denison Mattress Factory* v. *Spring-Air Co., supra*, at p. 410, and customer limitations, *Perma Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134, 136 n.4 (1968).

It is apparent, therefore, that the protection of Amway's trademarks and servicemarks carry weight in the determination of the legality of the vertical restraints it has imposed on the distributors.

Amway meticulously regulates advertising by its distributors. (Findings 94–108) Except for Amway's control of price advertising, *supra*, this control of advertising has adequate legal support. Amway has an "affirmative duty to itself and to the public to invoke some kind of control and restraint" in order to guard against misuse of its marks. *Denison Mattress Factory* v. *Spring-Air Co., supra*, at p. 409. The trademark licensor may properly regulate advertising or promotional materials in connection with the licensing of trademarks. **[105]** *Weight Watchers of the Rocky Mountain Region, Inc.* v. *Weight Watchers Int'l, Inc.*, 1976-2 Trade Cas. ¶ 61,157, at p. 70,225 (E.D.N.Y. 1976). And Amway had the right to regulate its distributors' advertising to stop infringement of its marks by unauthorized

[26] The rights of servicemark owners in this respect are the same as owners of trademarks. *Pro. Golfers Ass'n* v. *Bankers Life & Cas. Co.*, 514 F.2d 665, 668 (5th Cir. 1975)

publication in sales literature. *Amway Corp.* v. *International Sales Aids, Inc.,* 187 U.S.P.Q. 15, 21–22 (E.D. Ark. 1974).

Complaint counsel raise as a collateral issue the validity of three servicemarks. (CRB, p. 64) They argue that Amway distributors do not in fact perform services not normally connected with the sale of a particular type of product, and that a servicemark should not have been issued. Amway distributors do, however, perform valuable services for their sponsored distributors. (Finding 82) And Amway distributors provide valuable services to consumers, demonstrating and explaining products and delivering the products to the customer's home or place of business. (Finding 88)

Complaint counsel further attack the validity of the servicemarks, alleging "something highly improper" (CRB, p. 71 footnote) in an affidavit filed in support of the application for the servicemark. Although complaint counsel do not cite the record in this regard, they apparently refer to an error made in the application which referred to "trademark" rather than "servicemark." (Price, Tr. 2881) The context of the entire application shows that it involves a request for protection for a trademark for services.

Complaint counsel also argue that the application filed in support of the mark stated that it was for "door-to-door retail merchandising engaged in by the distributors," whereas respondents have discouraged "door-to-door" selling. (CRB, p. 72) The term "door-to-door" selling has a generic sense meaning "direct selling" as opposed to selling to retail stores. Amway advises its distributors to try to get an introduction from a neighbor, customer or friend before knocking on someone's door, although door-to-door canvassing is used by Amway distributors and it is "optional with them." (Van Andel, Tr. 1757–58) **[106]**

Counts IV and V of the Complaint

Counts IV and V of the complaint allege that respondents' system of distribution is unfair and involves misrepresentations concerning the nature of the system and the income distributors may gain from recruiting and fails to disclose distributors' substantial expenses and turnover.

Pyramid

Complaint counsel argue that the Amway Sales and Marketing Plan is inherently unlawful because it is "a scheme to pyramid distributors upon ever increasing numbers of other distributors." They argue that the Amway Plan, even without actual proof of economic failure, is "doomed to failure" and contains an "intolerable potential to deceive." (CB, p. 32)

This rule of *per se* illegality for pyramid plans has not yet been accepted by the courts. *Ger-Ro-Mar, Inc.*, 84 F.T.C. 95 (1974), *rev'd in part, Ger-Ro-Mar, Inc.* v. *FTC*, 518 F.2d 33, 37 (2d Cir. 1975); *United States* v. *Bestline Products Corp.*, 412 F. Supp. 754, 777 (N.D. Cal. 1976). The Commission defined such unlawful "entrepreneurial chains" in *Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1180 (1975):

> Such schemes are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell the 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. In general such recruitment is facilitated by promising all participants the same "lucrative" rights to recruit. (Emphasis in original.)

[107] Participants in the Koscot marketing plan paid an initial amount up to $5,000 to the company for inventory and the right to recruit others. The distributors who recruited others received $2,650 of the recruit's $5,000 payment. 86 F.T.C. at 1179. The only way a Koscot distributor could get the payment back was to recruit more distributors. 86 F.T.C. at 1131. Koscot and its distributors were primarily in the business of selling distributorships. 86 F.T.C. at 1140.

Participants in the *Ger-Ro-Mar, Inc.* marketing plan bought non-returnable inventory for up to $1,950. 84 F.T.C. at 108–10. Recruiters received compensation based on the fact of recruiting regardless of whether products were sold to the consumers. 84 F.T.C. at 148.

The pyramid marketing program in *Holiday Magic, Inc.*, 84 F.T.C. 748 (1974) required distributors to buy in at various levels for up to $4,500. At the highest level, distributors received $2,500 of the $4,500 for recruiting another distributor at the same level. 84 F.T.C. at 1032. The inventory purchased in this manner was non-returnable and the company paid little attention to consumers. 84 F.T.C. at 1035.

There is little doubt that a pyramid distribution scheme should now be condemned even without the demonstration of its economic consequences. The Commission has studied the effects of such "entrepreneurial chains" and seen the damage they do and a *per se* rule should be used. *Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1180–82 (1975). Such a rule would be based on demonstrated economic effect in these cases, rather than formalistic line drawing. *Continental T.V. Inc.* v. *GTE Sylvania Inc.*, 433 U.S. 36, 59 (1977). In such cases, the fact that some retail sales occur does not mitigate the unlawful nature of the method of recruiting. *Ger-Ro-Mar, Inc.*, 84 F.T.C. 95, 148–49 (1974), *rev'd on other grounds*, 518 F.2d 33 (2d Cir.

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1975). Here, however, the Amway system does not involve an "investment" in inventory by a new distributor. (Finding 61) A kit of sales literature costing only $15.60 is the only requisite. (Finding 34) And that amount will be returned if the distributor decides to leave Amway. (Finding 37) [108]

The Amway system is based on retail sales to consumers. (Findings 72–75, 144) Respondents have avoided the abuses of pyramid schemes by (1) not having a "headhunting" fee; (2) making product sales a precondition to receiving the performance bonus; (3) buying back excessive inventory; and (4) requiring that products be sold to consumers. (Patty, Tr. 3092–94). Amway's buy-back, 70% and ten customer rules deter unlawful inventory loading. (Findings 145–47)[27] Amway is not in business to sell distributorships and is not a pyramid distriubtion scheme. (Findings 142–44)

Saturation

The complaint alleges that distributors are not long likely to recruit other distributors because "recruitment of additional participants must of necessity ultimately collapse when the number of persons theretofore recruited has so saturated the area with distributors or dealers as to render it virtually impossible to recruit others." (Complaint, p. 9)

The term "saturation" as used in the complaint and by complaint counsel is one of the legitimate proofs in a case involving a pyramid distribution scheme. *Koscot,* 86 F.T.C. at 1135; *Holiday Magic,* 84 F.T.C. at 979; *Ger-Ro-Mar,* 84 F.T.C. at 119. Since Amway is not such a pyramid, the concept is immaterial here. [109]

Irrespective of the materiality of the concept, the facts in this record do not show that Amway distributors in any market were unable to recruit new distributors or to sell Amway products because of any inherent defect in the Amway Sales and Marketing Plan.[28] Products are consumed or wear out. (Patty, Tr. 3110) The population of the country continues to grow and to move about. Only one in four Amway distributors engage in recruiting, and there has been no decline in that percentage in recent years. The sales trend for Amway has shown almost uninterrupted growth. (Finding 151) The markets for Amway products and distributors, in short, are not static.

The preponderence of the evidence in the record does not support

[27] While the ten customer rule has a reasonable basis in preventing an unlawful pyramid, the distributors' monthly reports showing such sales need not specify the prices at which the sales were made. Such a requirement could be used to monitor unlawful resale price fixing.

[28] According to a market study conducted in 1973, only 4% of the distributors who did not renew their distributorship left because there were too many other Amway distributors in their area. (CX 521–E)

the allegation of "saturation." (Findings 148–52) From my observation of the demeanor, inconsistencies and uncertainties in the testimony of the witnesses called in support of the complaint in this regard, I believe the reason for their failure was more accurately described by a marketing expert who testified about this subject (Patty, Tr. 3109): "I think generally speaking when a salesman tells you that a market is saturated, he has become discouraged for some reason, usually he is simply not making the sales effort that is required." [110]

Misrepresentations and Failure to Disclose

The complaint alleges that respondents falsely represent that it is easy to recruit distributors and that distributors will receive substantial earnings. The complaint also alleges that respondents fail to disclose that there is substantial turnover among Amway distributors, and that substantial expenses are incurred in the business of being an Amway distributor. (Complaint, pp. 13–14) Misrepresenting to potential salespersons the nature of the position offered and the amount of compensation that will be received violates the Federal Trade Commission Act. *Encyclopedia Britannica, Inc.,* 87 F.T.C. 421, 488 (Initial Decision adopted by the Commission 1976).

Misrepresentations

The complaint alleges that respondents unlawfully represent that sponsoring is easy and profitable. (Complaint, pp. 10, 13) While words such as "easy" and "profitable" are relative, they can be the basis for a proper charge of unlawful misrepresentation. *Tashof* v. *FTC,* 437 F.2d 707, 712 (D.C. Cir. 1970); *Goodman* v. *FTC,* 244 F.2d 584, 597 (9th Cir. 1957); *Steelco Stainless Steel, Inc.* v. *FTC,* 187 F.2d 693, 697 (7th Cir. 1951); *contra, Carlay Co.* v. *FTC,* 153 F.2d 493, 496 (7th Cir. 1946). The facts, however, show that no unlawful misrepresentation has occurred.

Amway has represented that: "Sponsoring is easy!" Such isolated statements are found in detailed literature about the Amway Sales and Marketing Plan which must be read in context in assessing the nature of the statement. (Finding 139) Furthermore, Amway lets distributors know that the Amway Sales and Marketing Plan involves work. (Finding 130) In the introduction to the Career Manual for Amway Distributors, Mr. DeVos tells new distributors [111] that they are getting into the business on the "ground floor," starting "at the bottom," and that the Amway plan is an opportunity for all "who are willing to pay the price for success" and that the "person who thinks he can get big without working has no place here." (RX 331, p. 3–A)

In support of the allegation complaint counsel have proposed only the finding that three out of four distributors do not recruit. (CPF 525) This has little to do with the ease of recruiting because there has been no showing that all distributors are interested in recruiting rather than retail selling. Moreover, complaint counsel seem to admit that Amway has had no trouble recruiting distributors. (CB, p. 10).[29]

There is no doubt that the Amway Sales and Marketing Plan is designed to catch the interest of a prospective recruit by appealing to material interests. (Findings 59, 138) One approach is the "dream" sheet. Prospects are asked to describe their goals and dreams such as "a new car, a new home, college education for your children." They are, however, also asked: "Are you willing to work hard to get this?" (Finding 59)[30] [112]

Amway literature and speeches made at rallies by Amway representatives describe luxuries that may be available to Amway distributors. (DeVos, CX 1000–Z–3; Findings 59, 131) Guides for presenting the sales and marketing plan instruct the distributor to tell prospects (CX 190–J):

> For *you* the Amway Sales and Marketing Plan can mean the kind of life you've always dreamed of living, a new car, a new home, security . . . the things you want most out of life can be yours! Amway can be the means by which you achieve those things you've always dreamed of, but never thought you could afford. Amway can offer you an opportunity for true independence. Freedom from time clocks and freedom to travel *when* you want to. . . . [F]reedom from allowing someone else to decide your financial progress. (Emphasis in original.)

But the Amway plan also makes clear the idea that work will be involved, and that the material rewards to be gained will directly depend on the amount and quality of work done. (Finding 130) Complaint counsel argue that appealing to financial and material goals of salespersons is "emotionally exploitative." No applicable

[29] They argue that Amway has too many distributors and that Amway has "saturated" the market for distributors.

[30] Complaint counsel object to the "curiosity approach" that distributors have used when attempting to interest recruits. This involves getting the prospect to attend a meeting by a statement such as "we're in the business of helping professional people . . . start their own business," without mentioning the name "Amway." (Williams, CX 1116–S – T) At the meeting the full details of the Amway Sales and Marketing Plan are then explained. This approach was used primarily in the early 1970's because of the adverse publicity about pyramid plans unconnected with Amway. (CX 519–Z–49)

Amway distributors are not required to seek new distributors only by first announcing to prospects that they want to take their leisure hours away in a sales job. One distributor said that if this approach is used and ". . . you're talking to the guy that just came home from a factory maybe after ten hours, and is perspiring and looking at you and saying, 'Lady, you are one big dingaling if you think I'm gonna go out and do some more work after that.' " (Blinco, CX 1041–Z–3) precendent was cited or found that would hold such conduct unfair. [113]

Amway literature urges recruiters not to "quote dollar incomes on specific individuals even though you may want to use their stories about the homes in which they live, the cars they drive, or the airplanes they fly." (Finding 131)[31] Amway officers and other representatives have, however, orally stated specific dollar incomes which are attributed to Amway distributors. (Finding 132) These statements are typically made in mass sales rallies which are primarily for persons who are already Amway distributors. (Finding 48; CX 57-Z-118) The context of the sales talk is inspirational and it is to a knowledgeable crowd already aware of the details of the Amway Sales and Marketing Plan,[32] and in this motivational context the statements are obviously meant and understood to be feasible goals and not guaranteed average income for the listeners.[33] [114]

Amway recommends that distributors explain the Sales and Marketing Plan by using specific dollar amounts representing hypothetical retail and wholesale sales. (Findings 60, 134, 135) This method explains visually how to receive income by recruiting new distributors. It is frequently referred to as "drawing the circles" (CX 116-I) and shows expanding organizations of distributors in four or five examples, culminating in a hypothetical organization showing the sponsoring distributor receiving hundreds of dollars in monthly gross income. The diagrams start with a specific amount for the sponsoring distributor's hypothetical retail sales. From 1973 until 1977 this amount was $200 B.V.[34] Until recently Amway's circle diagrams showed the sponsored distributors' hypothetical sales also as $200 B.V. In 1977 recruiting literature, Amway changed these to more realistic varying amounts. (RX 401, pp. 7-9)

The circle diagrams have been qualified in the Amway literature to show that the illustration is hypothetical. (CX 162-G):

> For example, let's say you begin by sponsoring six new distributors. Just to illustrate the way the Amway Sales Plan operates, and not to suggest that there is any predictable level that any individual will ordinarily achieve, let us assume that each of the six sells an order a day . . . $5 a day . . . $100 per month . . . though actual sales will vary. . . .

[31] Specific examples of amounts paid to Amway distributors are well qualified in the literature to show that they are maximum amounts, not average. (RX 401, p. 10)

[32] Amway urges that recruiting be done individually rather than at mass meetings. (CX 638-H)

[33] For example, while urging distributors to open their minds to thinking in terms of making $100,000 a year, Mr. DeVos predicted that "there are going to be *some people* in the room" who were going to have that kind of income. (Finding 132) (Emphasis added.) This statement does not indicate that the average distributor can expect to make that amount. Examples cited in complaint counsel's proposed findings, when put in context, similarly show that the speakers are offering the specific amounts as goals not as representations of average incomes. (See the text surrounding the dollar amounts referred to in CPF 457, for example CX 990-Z, CX 992-H, CX 992-J.)

[34] Before 1973 it was $100; in 1977 it was raised to $250. (Finding 134; RX 401, pp. 7-9).

NOTE: Volume figures and earnings shown in this session are meant for *example* only. In actuality, distributors may show a variety of different volumes and earnings. Growth of an Amway group is not likely to work out in just this way.[35] (Emphasis in original.)

[115] The average Amway distributor sells far less than $200 a month. (Finding 137) The vast majority of Amway distributors are in the business part-time. Only one in four sponsors other distributors, and many apparently are distributors in order to buy Amway products—at about a 30% discount—which they consume. (Finding 137) For a dollar figure representing average sales by distributors engaged in active retailing of Amway products, however, the $200 is reasonable. (Cliett, Tr. 3759; Bryan, Tr. 4521)

Mr. Van Andel's reason for using the $200 figure is to act as a goal to motivate the distributors' sales. (Finding 136)[36] One of complaint counsel's [116] witnesses, Jack Wayne Hearne, a former Amway distributor, testified that he understood the $200 figure was a goal, not an average (Tr. 632-33):

Q. I believe you said that at the first meeting [the prospective distributors] were told that part of the plan was that everyone should try to sell $200 worth of products a month, that is correct?

A. Yes, and I asked why, and [the Amway distributor] said this is the basic thing that we work for. You are not required. If you do fine, if you don't fine, whatever. That was the goal you kind of worked toward.

The Amway literature stresses that retail selling is essential, and that sponsoring new distributors brings the responsibilities of training, motivating and supplying. The literature also warns the distributor never to give the imprssion that a business can be built only by sponsoring new distributors and not to quote dollar incomes by specific distributors or otherwise to imply that the plan is for anyone "who is unwilling to work hard." (RX 331, pp. 8-D, 9-D) In this context, it is clear that drawing the circles to show the Amway plan is not an attempt to deceive prospects into believing that such earnings are "typical" for Amway distributors, *Goodman* v. *FTC*, 244 F.2d 584, 595-96 (9th Cir. 1957), or that distributors "will obtain" the

[35] And distributors were warned: "In reality, some of your distributors will probably sell more than $200 P.V. while others may sell less; but just to make it easy to understand, we'll stick to the figure of $200 P.V. for purposes of this example." (CX 190-G; CX 201-G)

And Amway literature advises that: "As with retailing, depending on their own goals, initiative, and available time, and the retail sales of those they sponsor will vary." (CX 205-G; CX 208-F)

[36] The audience at opportunity meetings includes persons who are already distributors as well as prospective distributors. (CX 204-G) The "drawing circles" technique is used to teach these distributors the wholesale side of the Amway Sales and Marketing Plan and to set goals for these distributors, as well as to introduce prospective distributors to the plan.

amount specified. *Tractor Training Service* v. *FTC*, 227 F.2d 420, 425 (9th Cir. 1955), *affirming*, 50 F.T.C. 762, 769, 774.

For the same reason, there is no law violation in Amway's use of the $1000 figure as the earnings of a business which a distributor "may build." (Finding 138) There is no doubt that some Amway distributors earn that amount. (Finding 133) [117] It is used to entice prospects to an opportunity meeting where the details of the Amway Sales and Marketing Plan can be explained. In the context of the plan, it is clear that the amount is not meant to represent the average or typical earnings of an Amway distributor.[37]

Amway is not a "modern-day version of the chain letter." *Holiday Magic, Inc.*, 84 F.T.C. 748, 1035 (1974) The Amway system does not create the potential for massive deception present in a pyramid distribution scheme which relies primarily on the profits to be made from recruiting new distributors rather than from ultimate sales to consumers. (*Id.* at 1036) Unlike the pyramid companies, Amway and its distributors do not make money unless products are sold to consumers. The inherent potential for deception is not present in the Amway plan. In the full context of the plan, it does not have an unlawful capacity to deceive. [118]

Failure to Disclose

Respondents have not misrepresented the potential expenses incurred in running an Amway distributorship. Amway literature describes normal business expenses involved in conducting a distributorship, even assuming the distributors were not already aware of the existence of such expenses. (Finding 140)

The complaint also alleges that Amway has failed to disclose that there is a substantial turnover of persons recruited as Amway distributors.

Amway experienced a decline in the number of distributors recruited into its system starting about 1971. This lasted for a few years and was caused primarily by bad publicity concerning pyramid distribution companies. (CX 519-G, U) In recent years, the total number of Amway distributors has been increasing gradually and the rate of turnover has been falling. (Finding 148)

Direct selling companies typically have a high turnover among their independent salespersons. (Finding 162)[38] The rate of turnover

[37] In any event, prospective Amway distributors do not believe that they will make $1000 a month. On the application form for an Amway distributor, the applicants are asked to state their expected earnings. About 90% expect to earn less than $10,000 a year. About 75% expect less than $5,000, and more than half expect less than $2,000 a year. (CX 516-U)

[38] *Compare, Snap-On-Tools Corp.* v. *FTC*, 321 F.2d 825, 829 (7th Cir. 1963). Of 900 dealers of industrial tools, Snap-On had a turnover of from 350 to 700 in one and one-half years.

among Amway distributors has been lower than average among direct selling companies. (Findings 148, 162, 163) Furthermore, Amway warns its distributors that newly sponsored distributors can be expected to leave the business. (Finding 141) [119]

CONCLUSIONS

The Amway Sales and Marketing Plan is not a pyramid plan. In less than 20 years, the respondents have built a substantial manufacturing company and an efficient distribution system, which has brought new products into the market, notably into the highly oligopolistic soap and detergents market. Consumers are benefited by this new source of supply, and have responded by remarkable brand loyalty to Amway products. (Finding 186) The vertical restraints by which Amway has achieved this entry—avoiding conventional retailing through grocery stores by direct selling—are reasonable. Respondents' restraints on price competition, however, must be prohibited.

I therefore conclude that:

1. The Federal Trade Commission has jurisdiction over respondents and the subject matter of this proceeding.
2. This proceeding is in the public interest.
3. Respondents have agreed, combined and conspired with each other and Amway distributors to fix resale prices for Amway products, on sales between Amway distributors and to consumers, in violation of Section 5 of the Federal Trade Commission Act, 15 U.S.C. 45.
4. The attached order to cease and desist against respondents is appropriate, supported by the findings of fact, reasonably related to the offenses found, and necessary for the protection of the public interest.
5. The record does not support the allegations of Counts II, III, IV and V. Accordingly, those counts must be dismissed. [120]

Remedy

The order in this case should prohibit respondents in the future from controlling the prices charged for Amway products in sales between distributors and to consumers. And since the customer protection rule had that purpose and effect, the order must cover allocation of retail consumers.

As long as they obey the other rules herein found to be reasonable, distributors should have the right to advertise and sell Amway products, which they have purchased, at whatever price they wish.[39] "[W]here consumers have the benefit of price advertising, retail prices often are dramatically lower than they would be without advertising." *Bates* v. *State of Arizona*, 433 U.S. 350, 1977-2 Trade Cases, ¶ 61,573, at p. 72,330. [121]

ORDER

I

It is ordered, That respondents Amway Corporation and Amway Distributors Association of the United States, their officers, agents, representatives, employees, successors and assigns, and respondents Jay Van Andel and Richard M. DeVos, individually, and their agents, representatives and employees, directly or indirectly, or through any corporate or other device, in connection with the offering for sale, sale or distribution of any product, whether by combination, agreement, conspiracy or coercion, shall forthwith cease and desist from:

1. Fixing the price at which any distributor may advertise, promote, offer for sale or sell any product at retail.
2. Fixing the price at which any distributor may sell any product to any other distributor.
3. Requesting or obtaining any assurance to comply with, continuing, enforcing, or announcing any contract, agreement, [122] understanding, or arrangement with any distributor or prospective distributor which fixes the price at which any product is sold or advertised by such distributor or prospective distributor.
4. Threatening to withhold or withholding bonus payments or profit sharing payments from any distributor because of the price at which said distributor advertises or sells any product.
5. Requiring or requesting distributors to report the price at which products are resold, or to report the identity of any other distributor because of the retail price at which such distributor is advertising or selling any product; or acting on any reports or information about such retail prices by threatening, intimidating, coercing, terminating or contacting in any way the said distributor because of those reports or information. [123]
6. Terminating or taking any other action to prevent or limit the sale of any product by any distributor because of the retail price at

[39] Mr. Price, Amway's trademark attorney, testified that distributors can properly advertise that they are selling Amway products. (Tr. 2900-01)

which the distributor is advertising or selling any product, whether or not in conjunction with any of the Amway trademarks or servicemarks.

7. Publishing or distributing, directly or indirectly any wholesale or retail price list, order form, promotional material or any other document which employs resale prices for products sold by respondents without stating clearly and conspicuously in conjunction therewith the following: "The prices stated herein are suggested prices only. Distributors are not obligated in any way to adhere to any suggested prices. Distributors may determine for themselves the prices at which their product may be sold to other distributors or to consumers."

8. Allocating retail customers of distributors. [124]

II

Nothing in this order shall affect:

1. Respondents' rights in law and equity respecting the protection of respondents' trademarks or servicemarks in conjunction with the offer for sale or advertising of any product.

2. Respondents' rights to enforce the rules of the Amway Sales and Marketing Plan found reasonable in this decision.

III

It is further ordered, That respondent Amway Corporation, or its officers, agents, representatives, employees, successors or assigns, shall:

1. Within thirty (30) days from the effective date of this order, deliver a copy of this order to cease and desist to all present Amway Direct Distributors and distributors. From each Direct Distributor, a signed statement acknowledging receipt of this order shall also be obtained. [125]

2. Deliver a copy of this order to all future Amway distributors on the date of their participation.

3. Within thirty (30) days of the effective date of this order, make written offers of distributorships of equivalent value to the distributorship of any distributor who was terminated or suspended solely for the violation of rules, or policies which contravene any of the provisions of this order.

IV

It is further ordered, That respondents and their successors and assigns notify the Commission at least thirty (30) days prior to any proposed change in the corporate respondents such as dissolution, assignment or sale resulting in the emergence of successor corporations, the creation or dissolution of subsidiaries or any other change in the corporations or in the Amway Sales and Marketing Plan which may affect compliance obligations arising out of the order. [126]

V

It is further ordered, That the individual respondents promptly notify the Commission of any change of their present business relationship or employment. Such notice shall include respondents' business address and a statement as to the nature of change of business or employment as well as a description of their duties and responsibilities.

VI

It is further ordered, That the respondents herein shall within sixty (60) days from the effective date of this order, file with the Commission a report in writing setting forth in detail the manner and form in which they have complied with this order.

OPINION OF THE COMMISSION

BY PITOFSKY, *Commissioner:*

I. Introduction

In March 1975 the Federal Trade Commission issued a complaint charging respondents Amway Corporation ("Amway"), Amway Distributors Association ("ADA"), Jay VanAndel (Chairman of the Board of Amway and one of its two principal owners), and Richard M. DeVos (President of Amway and the other principal owner), with various violations of Section 5 of the Federal Trade Commission Act, 15 U.S.C. 45. The alleged violations involve the distribution network that has been built up to market the consumer products Amway manufactures. [2]

After extensive discovery, hearings began in May 1977 and were concluded in October 1977. In an Initial Decision rendered June 23, 1978, the presiding administrative law judge (the "ALJ") found that FTC counsel supporting the complaint ("complaint counsel") had established that respondents had engaged in illegal resale price maintenance, but had failed to establish that respondents had committed other violations of Section 5. We affirm the ALJ's decision with respect to resale price maintenance and, in addition, find that respondents have made false and misleading earnings claims in attempting to recruit persons to serve as distributors of Amway products. We also agree with the conclusion reached in the Initial Decision, that complaint counsel have failed to prove the other allegations made against Amway of unfair methods of competition and unfair or deceptive acts and practices. Specifically, we have determined that the Amway Sales and Marketing Plan is not an illegal "pyramid scheme"; that the non-price-related rules Amway has imposed on the distributors of its products, to control the way the products flow to consumers, do not constitute unreasonable restraints of trade or unfair methods of competition; and that, with the exception of certain earnings claims, respondents have not made false, misleading, or deceptive claims about Amway's business or the opportunities it presents to a person who becomes a part of it.

Amway has a highly unusual distribution system, and therefore a fairly extended description of Amway's business and marketing techniques is necessary as a prologue to the application of the relevant legal principles.

A. The Nature of Amway's Business

Amway was formed in 1959 by VanAndel and DeVos. It manufactures over 150 products, most of which are cleaning and personal care products. Soaps and detergents constitute 41 percent of sales; polishes, sanitation goods, and other cleaners 20 percent; toilet preparations 6.5 percent; pharmaceutical preparations 6 percent; and a variety of other consumer goods account for the rest. Amway's total sales topped $200 million in 1976, but Amway is still a small competitor compared to the giants that dominate the market in which it operates. The three largest firms in the soap and detergent market—Procter & Gamble, Lever Bros., and Colgate-Palmolive—account for over 80 percent of the total sales in that market. Procter & Gamble alone has about half these sales; in addition, it has about one-fourth of the total sales of personal care products. There are formidable barriers to entry into the market in which Amway operates; generally, a new competitor cannot enter at all unless it has very large amounts of money to spend on [3] advertising and promotion.[1] Amway skirted these near-insurmountable barriers and interjected a vigorous new competitive presence into this highly

[1] The three soap-and-detergent manufacturers mentioned above spent over $500 million in advertising and sales promotion in 1975. (Compare Amway's $200 million in sales.) Procter & Gamble alone—the largest advertiser in the United States—spent over $360 million in product promotion in 1975. Amway, by contrast, spent less than $1 million for advertising in 1975. Initial Decision, p. 68, Finding 175.

concentrated market by developing what is known as a "direct selling" distribution network.

B. Amway's Direct Selling Operation

Amway's products are the type usually sold in retail stores, especially in supermarkets. But Amway has totally avoided traditional retail outlets.[2] It retails its products directly to consumers on a "house-to-house" basis, using a sales force of about 360,000 independent distributors. Actually, Amway describes its retail marketing program as "person-to-person", since it encourages its distributors to seek out regular, repeat customers whom the distributors may service on an ongoing basis.

The advantages claimed for a direct selling operation include home delivery, explanation and demonstration of product characteristics and use, explanation of product guarantees, and other similar services. Amway has shown that these advantages can be considerable, as it has grown from sales of $4.3 million in 1963 to sales of over $200 million in 1976. One of the reasons for this rapid growth is that Amway's products have very high consumer acceptance. A marketing specialist called to testify at the hearings stated that Amway's laundry detergent, which has a very small market share and no national advertising, ranks third out of thirty-seven brands in brand loyalty. Other Amway products, including its automatic dishwasher detergent, detergent for fine clothing, bleach, rug cleaner, and laundry additives, each rank second in brand loyalty. Amway's liquid dishwashing soap led all sixteen brands surveyed in brand loyalty. [4]

C. Amway's Multilevel Distributor System

Each of the 360,000 Amway distributors is an independent businessperson. These distributors are governed in their relations with each other, with Amway, and, to some extent, with consumers, by the Amway Sales and Marketing Plan (the "Amway Plan").[3]

[2] Amway actually has a rule (in what is known as its "Rules of Conduct") which states that no Amway distributor shall permit Amway products to be distributed through any retail outlet. This rule, known as the "retail store rule," is discussed in greater detail at pages 21–23, *infra*.

[3] Generally speaking, the Amway Plan is a highly structured organizational outline, developed by VanAndel and DeVos to control the manner in which Amway products move through the distributor network to consumers. It is based on the "Code of Ethics and Rules of Conduct for Amway Distributors." The Amway Plan and the Code of Ethics and Rules of Conduct are set out in a manual, which Amway republishes every two to five years. The 197[illegible] edition of the manual, which was current at the time of the hearings and is therefore frequently referred to herein is called the Amway Career Manual; some earlier editions, also referred to herein, were called the Amway Sale Plan.

Under the Amway Plan, a select few distributors known as Direct Distributors[4] purchase products at wholesale directly from Amway and resell the products both at retail to consumers and at wholesale to the distributors they personally "sponsored" (that is, the distributors they recruited). Each second-level distributor resells the products both at retail to consumers and at wholesale to the distributors he personally sponsored. The third-level distributors perform the same two functions. This multilevel wholesaling network ends with those distributors who have not sponsored any new distributors, and who make purchases from their sponsors solely for their own use or for resale to consumers. Thus there is beneath each Direct Distributor a "field" of distributors, each of whom receives products which have flowed through each level between himself and the Direct Distributor.[5] Amway directs that these [5] products, regardless of how many levels they pass through, are to be sold between distributors at the same prices the Direct Distributor paid for them.[6]

All distributors are encouraged to make retail sales and to sponsor new distributors who will themselves make retail sales; distributors earn money for successfully engaging in either of these activities. The way a distributor makes money on a retail sale is simple. Each time he makes such a sale, he keeps the difference between the retail price at which he sold the product and the wholesale price at which he bought it. The way a distributor earns money from sponsoring new distributors is more difficult to understand and requires a more lengthy explanation.

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. This Bonus is basically a volume-based refund. The exact amount of the Bonus to be paid to a particular distributor is determined as follows. Each Amway product is assigned a "Point Value" (roughly corresponding to its wholesale cost) and a "retail value" (based on Amway's "suggested retail price" for that product). At the end of each month, a distributor adds up separately the total Point Value and the total retail value (referred to as his "Business Volume") for all the products he purchased that month from his sponsor (or, in the case of

[4] There were approximately 4000 Direct Distributors in 1977.

[5] Apparently some Direct Distributors have lines of sponsorship which are twenty to twenty-five levels deep. But of February 1977, approximately one-half of all Amway distributors either had a Direct Distributor as their sponsor were sponsored by a distributor who had a Direct Distributor as his sponsor. Over 70 percent of all distributors were the first three positions; over 85 percent were in the first four positions; over 93 percent were in the first five sitions; and roughly 99 percent were in the first seven positions.

[6] This restriction on wholesale pricing is discussed in greater detail at pages 12-13, *infra*.

a Direct Distributor, from Amway). He then computes the actual amount of his Performance Bonus by referring to the following "Performance Bonus Schedule," published by Amway:

IF YOUR TOTAL MONTHLY POINT VALUE IS:	YOUR PERFORMANCE BONUS IS:
7,500 or more points	25% of Your Business Volume
6,000 to 7,499 points	23% of Your Business Volume
4,000 to 5,999 points	21% of Your Business Volume
2,500 to 3,999 points	18% of Your Business Volume
1,500 ot 2,499 points	15% of Your Business Volume
1,000 to 1,499 points	12% of Your Business Volume
600 to 999 points	9% of Your Business Volume
300 to 599 points	6% of Your Business Volume
100 to 299 points	3% of Your Business Volume
less than 100 points	0% of Your Business Volume

[6] The Performance Bonuses are paid, in the first instance, by Amway to the Direct Distributors. Each Direct Distributor figures his Point Value and Business Volume for the month — both of which will include all the purchases he made from Amway to supply his own retail customers and to filter wholesale supplies down through the levels beneath him in his field or sponsorship — and is paid by Amway whatever percentage of his Business Volume he is entitled to. Each Direct Distributor is then responsible for paying out Performance Bonuses, from the amount he received from Amway, to the second-level distributors he sponsored.

The Direct Distributor usually will pay out less than he received from Amway, because these second-level distributors will each have a lower Point Value than he has, and they will therefore receive a lower percentage of their respective Business Volume amounts. For example, if five second-level distributors had each purchased a large enough volume of products in a month to be entitled to a 15 percent Performance Bonus, their Direct Distributor — in supplying their product needs as well as his own — would have purchased enough products from Amway to be entitled to a 25 percent Performance Bonus. The Direct Distributor would therefore be paid 25¢ by Amway on each dollar of his Business Volume, but he would only pay out 15¢ to his second-level distributors on each dollar of their respective Business Volumes. So the Direct Distributor would net a 25¢ Bonus on each dollar of Business Volume representing retail sales made by him to consumers, and a 10¢ Bonus on each dollar of Business Volume representing wholesale sales made by him to his sponsored distributors.

Each second-level distributor is then responsible for paying out

Performance Bonuses, from the amount the Direct Distributor pays to him, to the third-level distributors he sponsored. The second-level distributors will make money on the Business Volume generated by their sponsored distributors in the same way the Direct Distributors made money on the Business Volume generated by the second-level distributors; and so on, down through the successive levels of distributors.

This distribution hierarchy is not static, however, as any regular distributor, regardless of how many levels he may be below his Direct Distributor, may himself become a Direct Distributor by reaching a specified, high volume of purchases three months in a row.[7] When a regular distributor [7] qualifies as a Direct Distributor, he breaks out of the field of sponsorship he was in up to that time and begins to make his wholesale purchases directly from Amway. When a new Direct Distributor breaks out of his old position like this, he takes with him all those distributors he sponsored, all the distributors those persons sponsored, etc.[8]

D. Amway Distributors Association

The ADA is a trade association of Amway distributors.[9] Every Amway distributor is entitled to join the ADA, but only Direct Distributors may qualify as voting members. The voting members of the ADA meet once a year for a one-day meeting at which they elect nine of the eleven directors on the ADA Board. The other two directors — VanAndel and DeVos — are appointed by Amway. The Board performs three principal functions: it acts as a representative of the distributor association; it acts as an advisory board to Amway; and it acts as an arbitration board in disputes between distributors, or between Amway and a distributor.

II. The Alleged Violations

Complaint counsel have charged respondents with violations which fall into three categories. First, it is alleged that the Amway Sales and Marketing Plan is inherently deceptive, as it holds out the promise of "substantial income . . . as a result of . . . sales activities from . . . endless chain recruiting activities"; this is essentially a way of saying that the Amway Plan is an illegal pyramid scheme.

[7] *See* Initial Decision, p. 24, Finding 62, for a more exact statement of what is required.

[8] When a newly qualified Direct Distributor — who is by definition a very high volume performer — breaks out of his old place, it represents a great loss to the "old" Direct Distributor who previously funneled products to him. The old Direct Distributor is compensated by Amway for this loss by an additional monthly Performance Bonus consisting of 3 percent of the Business Volume of the new Direct Distributor.

[9] *See* Initial Decision, pp. 8-10, Findings 17-25, for a discussion of the history and origins of the ADA, and its relationship with Amway.

Second, it is alleged that various restrictions governing the sales, recruiting, and advertising activities of Amway distributors constitute unreasonable restraints of trade. Finally, respondents are charged with misrepresenting the profitability of a distributorship and the potential for recruiting and keeping new distributors. These charges will be taken up and discussed in order. [8]

A. Allegations That the Amway Plan Is a Pyramid Scheme

Complaint counsel argue that respondents have represented to prospective distributors that under the Amway Plan a distributor is likely to earn substantial income through a process of "multiplication" or "duplication", by recruiting others into the program who will themselves engage in recruiting, etc. Complaint counsel characterize the Amway Plan as "a scheme to pyramid by geometric growth layers of distributors." They state that "the Plan, by itself, is false, misleading and deceptive", because it leads to distributor saturation — that is, to such heavy concentration of Amway distributors that there is no one left to be recruited. The ALJ found that the record does not support these charges, and we agree.

The Commission had described the essential features of an illegal pyramid scheme:

> Such 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. . . .* As is apparent, the presence of this second element, 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. *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1180 (1975) (emphasis added), *aff'd mem., sub nom. Turner* v. *FTC* 580 F.2d 701 (D.C. Cir. 1978).

See also In re Ger-Ro-Mar, 84 F.T.C. 95 (1974), *aff'd in part, rev'd in part sub nom. Ger-Ro-Mar* v. *F.T.C.,* 518 F.2d 33 (2d Cir. 1975); *In re Holiday Magic, Inc.,* 84 F.T.C. 748 (1974). The Amway Plan does not contain the essential features described above, and therefore it is not a scheme which is inherently false, misleading, or deceptive.

The *Koscot, Ger-Ro-Mar,* and *Holiday Magic* cases all involved "marketing" plans which required a person seeking to become a distributor to pay a large sum of money, either as an entry fee (usually called a "headhunting" fee) or for the purchase of a large amount of nonreturnable inventory (a practice known as "inventory loading"). In exchange, the new distributor obtained the right to recruit others who would themselves have to pay a large sum of money — some of which would go to the recruiting distributor — to join the organization. [9]

By contrast, a person is not required to pay a headhunting fee or buy a large amount of inventory to become an Amway distributor. The only purchase a new distributor is required to make is a $15.60 Sales Kit, which contains Amway literature and sales aids; no profit is made in the sale of this Kit, and the purchase price may be refunded if the distributor decides to leave the business. Initial Decision, p. 12, Findings 34–37. Thus a sponsoring distributor receives nothing from the mere act of sponsoring. It is only when the newly recruited distributor begins to make wholesale purchases from his sponsor and sales to consumers, that the sponsor begins to earn money from his recruit's efforts. And Amway has prevented inventory loading at this point with its "buy-back rule," which states that a sponsoring distributor shall "[p]urchase back from any of his personally sponsored distributors leaving the business, upon his request, any unused, currently marketable products. . . ." By this rule, a sponsoring distributor is inhibited from pushing unrealistically large amounts of inventory onto his sponsored distributors in order to increase his Point Value and Business Volume, and thereby increase his Bonus.

Two other Amway rules serve to prevent inventory loading and encourage the sale of Amway products to consumers. The "70 percent rule" provides that "[every] distributor must sell at wholesale and/or retail at least 70% of the total amount of products he bought during a given month in order to receive the Performance Bonus due on all products bought . . . ." This rule prevents the accumulation of inventory at any level. The "10 customer" rule states that "[i]n order to obtain the right to earn Performance Bonuses on the volume of products sold by him to his sponsored distributors during a given month, a sponsoring distributor must make not less than one sale at retail to each of ten different customers that month and produce proof of such sales to his sponsor and Direct Distributor." This rule makes retail selling an essential part of being a distributor.

The ALJ found that the buy-back rule, the 70 percent rule, and the ten customer rule are enforced, and that they serve to prevent inventory loading and encourage retailing. Initial Decision, p. 26, Findings 72–75, and p. 58, Findings 145–47. Given these facts, the Amway plan is significantly different from the pyramid plans condemned in *Koscot, Ger-Ro-Mar,* and *Holiday Magic.* Specifically, the Amway Plan is not a plan where participants purchase the right to earn profits by recruiting other participants, who themselves are interested in recruitment fees rather than the sale of products. [10]

B. Distributor Restrictions

1. Direct Price-Related Restrictions

The ALJ found that Amway engaged in illegal resale price maintenance at both the wholesale and retail levels. Respondents argue before us that Amway merely suggests retail and wholesale prices. They argue there is no evidence in the record of current explicit agreements between Amway and its distributors, or of Amway enforcing its suggested prices through coercion of its distributors. What evidence of such conduct there is, they say, relates to acts and practices long since discontinued; and since there is no cognizable danger of a recurrence of these acts, they continue, an order prohibiting such acts is unwarranted. We reject respondents' arguments regarding Amway's wholesale and retail pricing practices, and affirm the ALJ's finding that Amway has engaged in illegal resale price maintenance.

As will be discussed below, evidence in the record conclusively demonstrates that Amway entered into explicit agreements with its distributors, in the past, regarding wholesale and retail pricing. And though Amway has discontinued the use of explicit agreements with respect to retail pricing, it still has explicit agreements with its distributors regarding wholesale pricing. Such explicit agreements to maintain resale prices are, of course, illegal per se. *Dr. Miles Medical Co.* v. *John D. Park & Sons Co.*, 220 U.S. 373 (1911); *United States* v. *A. Schrader's Son, Inc.*, 252 U.S. 85 (1920); *cf. Schwegmann Bros.* v. *Calvert Distillers Corp.*, 341 U.S. 384, 386 (1951). After it discontinued the use of explicit agreements regarding retail pricing, Amway started out merely suggesting a retail price; but it then engaged in acts which secured adherence to its plan and thereby produced a "combination" or implied agreement, which had a direct and substantial effect on retail prices. *United States* v. *Parke-Davis Co.*, 362 U.S. 29 (1960); *Albrecht* v. *Herald Co.*, 390 U.S. 145 (1968); *In re Holiday Magic, Inc.*, 84 F.T.C. 748 (1974). Finally, Amway required its distributors to agree to certain other rules regulating the distribution and advertising of its products, which serve to bolster and effectuate its retail price maintenance scheme.

As to the practices it has relied on in the retail pricing area since it discontinued the use of explicit agreements, Amway seeks to rely on the *Colgate* doctrine. In *United States* v. *Colgate & Co.*, 250 U.S. 300, 307 (1919), the Supreme Court said: [11]

[T]he [Sherman Act] does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell.

This language was interpreted to mean, as respondents state, in their Appeal Brief, at 12, that "a manufacturer [may] suggest resale prices for its products and independently . . . decline to do business with persons who resell the products at prices other than those suggested by the manufacturer." But cases decided since *Colgate* make it clear that the quoted language from that case was intended to create an exceedingly narrow exception. For example, in *United States* v. *Parke-Davis, supra,* the Supreme Court said:

An unlawful combination is not just such as arises from a price maintenance *agreement,* express or implied; such a combination is also organized if the producer secures adherence to his suggested prices by means which go beyond his mere declination to sell to a customer who will not observe his announced policy. 362 U.S. at 43.

Eight years later, in *Albrecht* v. *Herald Co., supra,* the Supreme Court raised the suspicions of many that *Colgate* was a dead letter when it stated that the *Colgate* exception might be exceeded if the sole evidence of a combination or conspiracy was that wholesalers and retailers, against whom a price maintenance plan was directed and enforced, had acquiesced in the plan. 390 U.S. at 150 n.6.

As will be developed in detail below, the evidence in this case establishes that Amway, in its efforts to secure adherence to its retail pricing plan, went far beyond the type of conduct that even a liberal reading of *Colgate* would allow. Specifically, Amway enlisted its distributors in a program designed to insure adherence to its stated pricing plan, and it structured certain of its Rules of Conduct so as to inhibit any kind of retail price competition among its distributors. Viewed against the background of the explicit agreements which Amway entered into in earlier years, these actions amply support a finding of illegal resale price maintenance. [12]

a. *Wholesale Prices*

Amway has illegally sought, and still seeks, to maintain its wholesale pricing policy through explicit agreement with its distributors. In a chapter of the 1975 Amway Career Manual[10] titled "The Amway Sales and Marketing Plan", Amway states: "[A distributor]

[10] *See* footnote 3 at page 4, *supra,* for a description of the Amway Career Manual.

cannot make money by simply selling products to his sponsored distributors because he sells them for the same price he paid for them: the distributor cost.[11]

Amway then converts this statement into a contractual provision by requiring a person seeking to become an Amway distributor to sign an application form which contains the following language:

> I agree to comply with the Amway Sales and Marketing Plan as set forth in official Amway Literature and manuals and to observe the spirit as well as the letters of the Amway Code of Ethics and Rules of Conduct. . . . I understand that my distriubtorship may be revoked if I fail to comply with the above provisions.[12]

[13] These explicit agreements are illegal *per se.*[13] *Dr. Miles Medical Co.* v. *John D. Park & Sons Co., supra.*

In addition, the "Distributor Order Form" (called an "SA-1"), which is published and circulated by Amway, instructs distributors to "consult the SA-13" for prices; an SA-13 is an Amway Wholesale Price List. Similarly, the 1975 Career Manual instructs distributors as follows: "Place your own order with your sponsor using the SA-1 Order Form. Use the Wholesale Price List to compute . . . Distributor Cost . . . for all items you have listed on the SA-1." Nowhere on any of these documents does it state that Amway's listed wholesale prices are "suggested" or "optional".

b. *Retail Prices*

In the retail pricing area, Amway originally used explicit agreements to prevent distributors from selling at less than Amway's specified retail price. In the 1963 Amway Sales Plan, the Rules of Conduct included the following rule: "No distributor shall sell

[11] Though worded differently at different times, the message has been the same down through the years. The 1963 Amway Sales Plan said: "[P]roducts sold between distributors are always sold at the same price, with no profit made on the immediate transaction. The profit is made later on the refund percentage." The 1968 Career Manual stated: "You sell Amway products to the distributor you sponsor at the same [price] at which you buy from your sponsor, and at which he buys from his sponsor."

[12] In the Career Manual itself, on the page facing the page containing the statement above about selling at distributor cost, Amway states:

> "[T]here is . . . . a binding contractual arrangement between Amway and its distributors, and that contractual arrangement is spelled out in detail not in a single printed document, but in a group of documents. Amway has always considered itself bound by a contract consisting of the following: . . . the Career Manual. . . ."

[13] As noted at page 5, *supra*, Amway does indicate in a " Performance Bonus Schedule" the percentage of a distributor's monthly Business Volume that he is to receive as a Bonus from his sponsor. If there were an agreement between Amway and its distributors at various levels that the distributors would adhere to this Schedule in paying out Performance Bonuses to the distributors they sponsored, it arguably would be an agreement with a substantial and direct effect on wholesale prices and would be illegal *per se. Cf. United States* v. *Socony-Vacuum Oil Co.*, 310 U.S. 150, 221 (1940). But there is no evidence that Amway or its distributors regard the Schedule as binding with respect to specific percentages. There is also no evidence that Amway enforces adherence to the percentages set out in the Schedule, nor even that most distributors do in fact adhere to those percentages. Findings 54 and 68 of the Initial Decision, at pp. 16, 25, indicate only that Amway enforces its rule that the Performance Bonuses it pays out to the Direct Distributors must be filtered through the distributor network, but not that the percentages Amway sets out are binding.

products sold under the Amway label for less than the specified retail price . . . ." Also included in this manual was a copy of the application a prospective distributor must fill out; each applicant was required to sign on the application underneath the following pledge: "I agree to observe the spirit as well as the letter of the Code of Ethics and Rules of Conduct of Amway Distributors." [14]

Respondents claim that the rule requiring adherence to Amway's retail prices was abolished in 1965. But as the ALJ pointed out, the record does not show that Amway has ever clearly told its distributors that they are free to set their own prices on retail sales to consumers.[14] Initial Decision, p. 87 n.12. Rather, it has signaled in several ways that it continues to regard fixed resale prices as being in everyone's mutual interest.[15]

Evidence presented at the hearing indicates that Amway has continued its efforts to secure compliance with its retail pricing policy long after it deleted the inculpatory language from its Rules of Conduct; in so doing, it has stepped well outside the protective parameters of *Colgate*. Specifically, it has invited its distributors to participate in a general scheme to detect and deter price cutting. For example, in a 1971 speech to a meeting of Direct Distributors,[16] DeVos was asked several questions by persons in the audience about what could be done with price cutters. He stated: [15]

> If you have a distributor who is selling Amway products at wholesale to a customer, our action has got to be first of all to get a complaint on it and find out who the distributor is that's doing it. Our next move has got to be to work on his removal, but this isn't an easy problem, because if this person wishes to sell to anybody on the street at whatever price he wants to, you're getting into some touchy areas on price-fixing. . . . Now you can try all the devious things you want to, to prevent this indiscriminate guy from price cutting . . . . [Y]ou can go ahead and delay shipments to him, you can berate him, you can lecture him. . . . Say [to him], "if you want to play price cutting game with your customers just let me know who they are because I make 25% and I'll go in and cut you right off. See, if its price cutting you want I'll show you how to play the game. Because I've got more money to play with than you have, haven't I?"[17]

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[14] Amway sends to distributors retail price lists for Amway products. The 1965 price list referred to the prices thereon as "retail". The 1970 price list used the phrase "retail prices (for sales tax purposes)". The current price list states that the prices listed are "suggested retail".

[15] In a 1970 copy of "The Amway Amagram" (a newspaper-like publication sent by Amway to its distributors), an article contained statements made by VanAndel to a meeting of Direct Distributors. He told them that Amway had conducted a test, in which it had divided the country into half, with prices set at normal levels in one half and at very high levels in the other half. He continued:

> "We wanted to see how much difference price would make in our marketing system. Actually, the sales volume per distriubtor in the higher price area was considerably higher than that in the other. I don't mean just 5% or 10%, I think it was over 50%. We concluded that higher price encouraged distributors to do more selling so he could make extra profit."

[16] This speech, along with several others, was tape-recorded live; the tapes of these speeches were admitted as evidence at the hearings.

[17] During this speech DeVos also said in regard to price cutting: "I can't do much about it. And I don't think you can do much about it." He added: "[Y]ou don't stand a legal chance of doing anything about it . . . . I can't

(Continued)

He went on in the same speech to caution the Direct Distributors to "guard against anything that's dog eat dog." He warned them that "price fixing is one of the things that the federal people and the FTC watch like a hawk," and advised them to talk to price cutters but not to write to them, because "when the FTC grabs that letter they'll say you're . . . price fixing." To say the least, the tactics recommended in this speech "go beyond mere announcement of [a] policy and [a] simple refusal to deal," and constitute "other means which effect adherence to [specified] resale prices." *United States* v. *Parke-Davis & Co., supra,* 362 U.S. at 44.

Similarly, Mr. Halliday — Amway's Executive Vice President and one of its three directors — told a meeting of Direct Distributors that if they learned of a distributor cutting prices, they should go to talk to that person's Direct Distributor and seek to persuade the price cutter to [16] stop. He added: "You're gonna have to work with him on an informal basis. As far as our being able to write him and saying 'You can't do it,' we cannot." This sounds far more like the invitation to acquiesce which the Supreme Court found unacceptable in *Parke-Davis* than the unilateral refusal to deal which might have some remaining vitality under *Colgate.*[18]

Amway has taken additional steps, beyond counseling Direct Distributors on how to deal with price cutters, to insure that price competition among distributors is thwarted. The clearest example of Amway's additional efforts to support its general price maintenance scheme is the "customer protection rule." This rule, which was included as one of the Rules of Conduct up until 1972, provides that each time an Amway distributor makes a sale to a retail customer, he obtains an exclusive right to re-sell to that customer for a thirty day period; if the distributor does make another sale to the customer within that period, he extends his exclusive right for another thirty days.

The ALJ found that the purpose and effect of the customer protection rule was to prevent price competition. Initial Decision, p. 89. This finding is supported by the obvious effect of the rule, and by Amway Vice President Halliday's statement that the purpose of the

take any action on it without endangering everybody in a federal restraint of trade activity." But these statements, essentially recognizing the dangerous legal problems that can arise from resale price maintenance and recommending caution in efforts at coercion, do not offset the clear meaning and effect of the other statements quoted above.

[18] Respondents rely heavily on *Knutson* v. *Daily Review, Inc.*, 548 F.2d 795 (9th Cir. 1976), *cert. denied,* 433 U.S. 910 (1977), for the proposition that where an explicit agreement is abandoned and is succeeded by strong recommendations of resale price maintenance, those recommendations do not constitute a "combination" in the absence of evidence of special coercion. But *Knutson* is not applicable here because Amway has gone far beyond "recommending": it has induced other distributors to assist in its program of detecting and deterring price cutting, and it has attempted to extract agreement and acquiesence from its distributors. *See* Initial Decision, pp. 39, 41–44, Findings 115, 117.

rule is "to prevent cut-throat competition" between distributors. Initial Decision, p. 88.

Respondents point to the fact that this rule was deleted from the Rules of Conduct in 1972; they claim this is evidence of discontinuance. However, in a speech to a meeting of Direct Distributors in 1974, Halliday reminded his listeners that the Golden Rule is the first rule in the Amway Code of Ethics[19] and then stated: [17]

> To what extent do you want to go in cutting out another Amway distributor? You have the absolute right to do it — the law says . . . there is no protection of customer under those circumstances. But you see, sometimes there's a — something above and beyond the law that you have to think about in terms of ethics.

Also, in the "Know-How Success Course", a training booklet used through 1974, sponsors are taught to test their recruits' knowledge of Amway policy with a quiz, which contains the following two questions (with their respective "right" answers):

> 9. Before you complete a sale to a new customer, is it important to ask if that customer is presently being serviced by another Amway distributor? YES or NO.
>
> - YES
>
> 10. As long as one distributor maintains exclusive right to resell a customer, no other Amway Distributor may sponsor that customer. TRUE or FALSE.
>
> - TRUE

These statements, coming as they did on top of an explicit rule in the recent past, undercut any argument of discontinuance.

In addition, Amway has tailored some of its otherwise reasonable Rules of Conduct to detect and prevent retail price cutting among distributors. An example is the ten customer rule (discussed at page 9, *supra*), which provides that a distributor must produce proof of retail sales to at least ten customers each month before he can receive his Performance Bonus. This rule has the reasonable purpose and effect of tying compensation to the retail sale of products. But it also serves as a detection device with regard to price cutting, because the "proof" a distributor must produce is a copy of the retail sales slip, which, by another rule, must "state the price charged". This aspect of the ten customer rule also has an obvious *in terrorem* effect on distributors who might be inclined to sell at less than Amway's "suggested" retail price. [18]

Two other rules currently included in the Rules of Conduct have had the effect of "shoring up" Amway's retail price fixing scheme.

[19] This literally is true, as the first provision of the Code reads: "I will make the 'Golden Rule' my basic principal of doing business. I will always endeavor to 'do unto others as I would have them do unto me.' "

The buy-back rule (discussed at page 9, *supra*) provides that a sponsoring distributor must buy back any products he sold to a sponsored distributor who has decided to go out of business. A 1973 Amway Legal Bulletin explained that one of the reasons for this rule is to insure that a distributor who is leaving the business does not "attempt to sell the products at a discount." *See* Initial Decision, pp. 44–46, Findings 120–23. The "fund-raising rule" provides that a distributor may sell certain Amway products in fund-raising drives held by church, service, civic or charitable organizations "provided such sales are made in accordance with the Amway Fund-Raising Plan." Under this plan (as it is described in the 1975 Career Manual), the selling organization only takes orders for the products; the orders are then turned over to an Amway distributor, who delivers the products, collects the purchase price, and pays an agreed-upon profit to the selling organization. Amway argues that the reason an Amway distributor is sent to deliver the product and pick up the purchase price is to allow the distributor to initiate contact with the purchaser. This argument might be convincing were it not for the history of this rule. The 1968 Amway Career Manual — which was distributed at a time when the charitable organization took sole responsibility for delivering the product and collecting the purchase price — gave the following advice to distributors supplying a fund-raising organization: "See that standard retail prices are observed. Do not permit cut-rate selling. Cut-rate selling during a fund-raising campaign could hurt your own regular selling of these items."

We do not say that the ten customer rule, the buy-back rule, and the fund raising rule are illegal in their entirety in this case. We do say that certain aspects of these rules, discussed above, as implemented here — with the plain purpose and effect of assisting in a program of illegal resale price maintenance — are illegal under Section 5 in that they contribute to a resale price maintenance program, *cf. National Society of Professional Engineers* v. *United States,* 435 U.S. 679, 692–93 (1978), and also that they are evidence of a purpose on the part of Amway to maintain an overall price maintenance program.[20] Initial Decision, p. 37, Finding 112. [19]

In a further effort to deter price competition, Amway has sought to prevent its distributors from advertising prices for Amway products.[21] Initial Decision, pp. 43–45, Findings 117, 119, 121. It has done

[20] The portions of the Final Order relating to rules (Order Paragraphs I.4, I.7, and I.8) are aimed solely at preventing their use in connection with the maintenance of retail prices; the Order does not otherwise disturb their operation.

[21] *See* pages 23–24, *infra,* for a detailed discussion of the advertising restrictions Amway has imposed on its distributors.

this by converting a series of restrictive advertising rules contained in its Rules of Conduct into contractual provisions,[22] and by terminating, or threatening to terminate, distributors who advertise Amway products at discount prices.[23] Besides contributing to Amway's overall scheme to control resale prices, this elimination of price advertising is a *per se* violation of Section 5. *See, United States* v. *Gasoline Retailers Asso., Inc.,* 285 F.2d 688, 691 (7th Cir. 1961); *United States* v. *The House of Seagram,* 1965 Trade Cases (CCH) ¶71,517, p. 81,275 (S.D. Fla. 1965); *cf. National Society of Professional Engineers* v. *United States,* 435 U.S. 679, 692–93 (1978). Moreover, this restriction on price advertising is evidence, along with the other price-related rules and practices discussed already, of Amway's intent to eliminate price competition in the retail sale of Amway products.

Finally, there is an additional, slightly different reason why Amway's retail pricing policy is illegal. This is not a situation, like *Colgate,* where a manufacturer is imposing its retail pricing policy on a corps of resistant, or even neutral, wholesalers and retailers. Rather, there is evidence that the ADA Board of Directors — which is the representative of Amway's distributors — agrees in advance with Amway on what the retail price of particular products is going to be. *See* Initial Decision, p. 27, Finding 79. In its Non-Profit Corporation Annual Report filed with the state of Michigan in 1975, the ADA stated that the "Purpose of the Corporation" was: "To act as a trade association for the purpose of setting policies with the company from whom purchases are made *and the pricing of all products sold direct to the consumer*" (emphasis added). Respondents have attempted to characterize this language as "inaccurate boilerplate". We find this characterization unpersuasive. [20]

c. *Respondents' Claims That Price Competition Does Exist*

Respondents argue that distributors do, in fact, demonstrate considerable independence and flexibility in wholesale and retail pricing. And several distributors (mostly Direct Distributors) who testified at the hearings were asked whether they were required by Amway to resell Amway products at a certain price, and answered "No". In addition, some of these distributors testified that they occasionally do sell for less than "suggested" retail or wholesale. However, as the ALJ observed, it is not surprising that out of a group

[22] *See* page 12, *supra,* for a discussion of how Amway converts the Rules of Conduct into a contract between Amway and each distributor.

[23] *See* Initial Decision, pp. 41–46, Findings 117, 119, 121, and p. 90. Also, Amway advises its distributors, in the Career Manual, that when a distributor violates one of the Rules of Conduct his Direct Distributor "may take such corrective action as he deems necessary, even terminating the violator's distributorship."

of 360,000 distributors, a few could be found who do "discount". Initial Decision, p. 88 n.13. The ALJ still found that the record showed that the vast majority of Amway distributors do not cut the retail price of Amway products. Initial Decision, p. 47, Finding 127. We agree with this finding.

Respondents also claim that substantial retail discounting is evidenced by the retail sales tax refunds Amway pays out to distributors. Amway collects retail sales tax, based on its suggested retail prices, from the Direct Distributors at the time it sells products to them wholesale; this is done at the request of state taxing authorities. *See* Initial Decision, p. 46, Finding 124. This sales tax is passed along in each wholesale sale of products, and is ultimately recouped at the time a product is sold at retail. Respondents point to the fact that a distributor may apply for a refund of some or all of this amount if he sells a product at less than Amway's suggested retail price. And in fact, respondents state, a large amount of money is refunded each month from Amway's sales tax collections. But complaint counsel point out that there are many reasons why a distributor could be entitled to a refund of some or all of the retail sales tax he paid, including: sales across state lines with different tax structures, sales to tax exempt organizations, and, most importantly, distributor home consumption.[24] Indeed, this "request-for-refund" policy could itself be ancillary to Amway's price maintenance plan if it were used as a means of learning which distributors have made sales at less than "suggested" retail. [21]

We conclude on the record that Amway has illegally sought to enforce its resale price policies, and, judging by market effects, has enforced them successfully throughout most of its distributor network.[25]

2. Other Challenged Distribution Restrictions

Complaint counsel also allege that two other Amway rules and restrictions — the "cross-group selling rule" and the "retail store rule" — violate Section 5 as unreasonable restraints of trade. The prohibition on cross-group selling, sanctified in Amway's Rules of Conduct, provides that a distributor must buy all his products from

[24] The ALJ found that home consumption of Amway products by distributors accounts for a significant amount of Amway's sales. *See* Initial Decision, pp. 55-56, Finding 137.

[25] Where a finding of resale price maintenance has been made, we routinely include in the order a provision prohibiting the use of suggested prices for some time after entry of the order. But in this case there are highly unusual circumstances which make the use of suggested resale prices not anti-competitive. Specifically, Amway has an unusual distribution system which relies on the sales efforts of hundreds of thousands of distributors, many of whom distribute Amway products part-time and are inexperienced in business matters generally. It is not unreasonable under these circumstances to give distributors some guidance in setting prices on the 150 products they try to sell.

his sponsor; by implication, a distributor may not sell Amway products to a person sponsored by someone else. The retail store rule — also one of the Rules of Conduct — provides that no distributor shall permit Amway products to be sold or displayed in "retail stores" or "other types of retail establishments, which are not technically stores, such as barber shops, beauty shops, etc."

Complaint counsel have characterized these restrictions as *per se* violations of Section 5, either as part of a plan to maintain prices, or as market division schemes horizontally imposed. We reject both these contentions. As to the price fixing charge, we have already found that Amway has entered into a series of express agreements and/or implied combinations with its distributors fixing wholesale and retail prices. There is no evidence on this record that the retail store rule or the cross-group selling rule were adopted to implement those vertical price fixing agreements, or that they contributed to that effect. If Amway's direct efforts at resale price maintenance are elimiated — as they should be through the order imposed here — there is no reason to believe resale price maintenance would persist as a reult of these two rules. [22]

If the restraints embodied in the cross-group selling and retail store rules were horizontally agreed to or induced, rather than vertically imposed by Amway on its distributors, the agreements would probably be illegal *per se* as horizontal divisions of market. *See United States* v. *Topco Associates, Inc.*, 405 U.S. 596 (1972); *United States* v. *Addyston Pipe & Steel Co.*, 85 F. 271 (6th Cir. 1898), *aff'd.*, 175 U.S. 211 (1899). Complaint Counsel claim that the ADA was formed before Amway, and that therefore the ADA must have been the source of all distributor restrictions. We do not find this approach conclusive on this question. Furthermore, the ALJ found that VanAndel and DeVos formed the ADA, at a time when they were distributing another manufacturer's products through a direct selling organization, in anticipation of starting their own manufacturing company. Initial Decision, pp. 8–10, Findings 17–25. Complaint counsel established that there is a constant dialogue between Amway and the ADA Board regarding the nature and consequences of the Amway Plan. But it does not follow that Amway is obligated to adopt, or does adopt, the recommendations or requests of the ADA Board when Amway is otherwise inclined to take different action or to take no action at all. It is likely that the dialogue exists primarily for the purpose of making the distributors — especially the Direct Distributors, who are linchpins in the Amway Plan — feel that they are an important part of the Amway organization and that their views and opinions are highly regarded. *See* Initial Decision, pp. 81–

82. Complaint counsel also point to the fact that VanAndel and DeVos, the two principal owners of Amway, are themselves the joint heads of a Direct Distributor organization. However, other than stating in their Appeal Brief, at 43, that the two men have "one of the largest Amway Direct Distributorships in the country," complaint counsel have provided no information or evidence on this point. All in all, we feel there is not sufficient evidence to support a finding that the Amway Rules of Conduct are not "essentially" vertical. Therefore they will be analyzed individually under the rule of reason. *Cf. Continental T.V., Inc.* v. *GTE Sylvania, Inc.,* 433 U.S. 36 (1977).

The cross-group selling rule, which applies only to distributors' wholesaling functions, was found by the ALJ to be "the basis for the Amway Sales and Marketing Plan":

It provides the structure by which products, information and compensation flow from Amway to the Direct Distributors and down to the distributors engaged in making the retail sale. It provides lines of communication and responsibility insuring that distributors are properly trained and [23] motivated and that consumers receive services provided under the Amway system of distribution. Used in conjunction with the performance bonus system, the cross-group selling rule gives sponsoring distributors an incentive to recruit, train, motivate and supply other distributors in order to gain a reward based on the sponsored distributors' sales volume. If sponsored distributors could buy Amway products from someone other than their sponsor, that incentive would not exist. Initial Decision, p. 100 (citations omitted).

We endorse this finding and conclude that the vertically imposed cross-group selling rule is reasonably ancillary to compensation, efficient distribution, and training. Given the large number of existing and potential distributors of Amway products, Amway's small size compared to its major competitors, and the direct relationship between the limitation on cross-group selling and the achievement of efficiencies within Amway's unique distribution system, we agree with the ALJ that the restriction is reasonable. *Continental T.V. Inc.* v. *GTE Sylvania, supra.*

The ALJ found that the retail store rule preserves Amway's direct-selling operation and consumer demand for Amway products, and provides an incentive to distributors to furnish special services to consumers:

Marketing experts gave credible testimony in this proceeding that if Amway products were sold in retail stores, distributors would lose interest in calling on consumers' homes, demonstrating and explaining products to create a demand which could be satisfied — perhaps at a lower price — at a retail store. Without a demand for the products, retail stores would soon lose interest in Amway products. Amway would then be faced with the necessity of creating demand in the traditional way of advertising expenditures and otherwise doing battle in the retail grocery stores, in a

> hostile oligopolistic marketplace. . . . The retail store rule gives Amway distributors an incentive to provide services to consumers and to create a consumer demand which would dissipate if Amway products were sold in retail stores. Amway distributors demonstrate and explain Amway products [24] and deliver to the consumer's home. These services are typically unavailable from retail stores. Because some Amway products are more concentrated than products sold in retail stores, demonstration and explanation are essential to consumer demand. Initial Decision, pp. 98-99 (citations omitted).

We endorse this finding as well. Since neither Amway nor any of its distributors can sell through retail outlets, this is not an instance where existing competition between different distributors or classes of distributors is being curtailed. Given Amway's small size (compared to its competitors), the plausible business reasons for the restrictions (relating mainly to Amway's ability to recruit distributors and induce them to provide special services), the absence of evidence that retail stores are excluded principally because of a belief that they would be price cutters, and the armies of distributors seeking to sell Amway products to all who wish to purchase them — we agree that complaint counsel has failed to show that this restriction is unreasonable.

3. Advertising Restrictions

Amway exercises a strong control over advertising by its distributors. It has placed especially severe restrictions on product advertising. One of the Rules of Conduct states: "No Amway distributor may produce or procure, from any source other than Amway, any literature relating to the Amway Sales and Marketing Plan or any Amway product." Thus the first rule on product advertising is that Amway has total control over what is actually said. Amway insists this restriction is necessary to protect its 125 registered trademarks and servicemarks, and to insure that its products are intelligently and consistently described.

Another rule provides that only Direct Distributors may advertise on radio, television, or in newspapers, and then only if they use ad mats and scripts obtained from Amway. Thus a distributor who is not a Direct Distributor may not advertise Amway products by any means other than hand- or mail-delivery of Amway sales aids and promotional materials. Amway claims it is reasonable to deny regular distributors the right to advertise products on radio, television, and in newspapers, because most distributors are inexperienced in business and tend to overestimate the effectiveness of advertising; if they were turned loose to advertise as much [25] and by whatever means they chose, many of them would unjustifiably increase their expenses to the point where they were driven from the market. In addition, respondents say, there is rapid turnover among distributors, and it would have a negative impact on Amway's image if consumers responded to ads placed by distributors who had since gone out of business.

The ALJ found these restrictions reasonable. Initial Decision, pp. 104–05. We concur in this finding, except that we find one aspect of Amway's restrictions on product advertising unnecessarily restrictive and ancillary to Amway's price maintenance scheme. Specifically, none of the Amway-designed sales aids, promotional literature, ad mats, or ad scripts provides a place for the advertising distributor to list his own retail price for the products advertised. And since no distributor may advertise Amway products other than by using the advertising materials designed and distributed by Amway, it follows that price advertising is effectively prohibited. To protect its servicemarkets and trademarks, Amway may — in reasonable ways that are not anticompetitive — prescribe the means by which distributors advertise products and the words they use; but Amway may not foreclose distributors from advertising product prices. *United States* v. *Gasoline Retailers Asso., Inc.*, 285 F.2d 688, 691, (7th Cir. 1961); *United States* v. *The House of Seagram,* 1965 Trade Cases (CCH) ¶71,517, p. 81,275 (S.D. Fla. 1965); *cf. National Society of Professional Engineers* v. *United States,* 435 U.S. 679 (1978).

Amway also restricts the use by distributors of the Amway name and logo on the exteriors of wholesale offices and automobiles, on checks, and in telephone directories. It restricts outdoor advertising on billboards or signs, and allows distributors to use the Amway name in classified recruiting advertisements only if the ads follow word-for-word one of seventeen formats provided by Amway. Finally, all Amway printed material is copyrighted and may not be reproduced by distributors without permission. The ALJ found these reasonable. *See* Initial Decision, pp. 32–35, Findings 94–108, and pp. 104–05. We question whether some of these restrictions are reasonably related to Amway's legitimate business needs; but we agree that complaint counsel have offered no plausible evidence from which we might conclude that the purpose or effect of these various restrictions is anticompetitive. **[26]**

C. Misrepresentations

Respondents were charged in the complaint with making false, misleading, and deceptive statements concerning the profitability of a distributorship. Specifically, complaint counsel claim respondents have affirmatively misrepresented distributors' earnings and recruiting potential, and have omitted material facts about business expenses and turnover among recruited distributors. Together, it is charged, these misrepresentations and omissions have the capacity to deceive distributors and potential distributors.

The different kinds of alleged misrepresentations involved are discussed in detail in the Initial Decision at pages 17–23 and 48–57. Most come from the 1975 edition of the Amway Career Manual, from the section advising a would-be sponsor on how to go about recruiting a new distributor. The method employed consists of explaining the Amway plan and appealing to the financial goals of the recruit. The ALJ found that, viewed in context, none of the statements challenged constitutes an illegal misrepresentation. Initial Decision, pp. 110–18. With the exception of those statements which make unrealistic earnings or sales claims, we affirm this finding.

The "non-earnings" claims made by Amway — which generally consist of vague references to the achievement of one's dreams, having everything one always wanted, etc. — are phrased in terms of "opportunity" or "possibility" or "chance"; and they are surrounded by warnings that hard work is required. We believe that these claims are primarily inspirational and motivational; to the extent that they dangle the likelihood of financial security and material success before the potential distributor, they constitute vague "puffs" which few people, if any, would take literally; and in any event, they are accompanied by appropriate qualifiers.

The same cannot be said, though, for certain statements and claims which contain references to specific dollar amounts which distributors are likely to earn. For example, in the 1975 Career Manual, Amway advises recruiting distributors to announce to persons they are trying to recruit that Amway offers an opportunity to "develop an income of as much as $1,000 per month." Amway also advises recruiting distributors to ask questions like the following:

How much money per month do you need for that new car? $100 a month or more?

What kind of home do you want — a three-bedroom ranch — with a price tag of $35,000–$40,000? [27]

How much will it take to send the youngsters through college — $2,500 to $3,000 a year for each younster? If you could earn an extra $250 a month, you would have an additional $3,000 a year. This might be sufficient to send one youngster through one year of college.

How much would you like as a continuing income — $100 a month?

But not all of Amway's recommended recruiting claims are so generalized. At one point in the Career Manual it states: "If you make 'two sales a day . . . the Amway way' on each of 20 days per month, your retail sales can easily amount to $200.00 per month even though you work less than an hour per day." The Manual uses this $200 figure again when it instructs a recruiting distributor on how to "draw the circles" — a device used to explain the way a distributor earns a Performance Bonus off the purchases made from him by the distributors he has sponsored. He is advised to state: "Let's say, for example, that you sponsor six distributors and that each one of these distributors starts his own retail business selling $200 a month." He then draws a big circle, representing the sponsor, and six smaller circles, each of which represents a sponsored distributor. The figure $200 is written into each of these six smaller circles to indicate that each sponsored distributor has a Business Volume of $200 per month. The recruiting distributor then does a series of calculations showing the Performance Bonus the sponsor will earn as a result of having six sponsored distributors with individual monthly Business Volumes of $200. In the example of this diagram included in the Career Manual, the following language is placed above the circles: "For discussion purposes, let's round out the numbers to $200.00. I'm sure you realize that some will do much less and some more. But, if they make two sales a day, they should sell at least $200 (at BV) per month." But in spite of this prominent disclaimer, the impression is created that $200 is a typical or average monthly Business Volume.[26] [28]

In fact, the record shows that in 1969–70 the average monthly Business Volume of Amway distributors was about $20, and in 1973–74 it was about $33.[27] Initial Decision, pp. 55–56, Finding 137. And while some Direct Distributors do have annual Business Volumes in the thousands of dollars, they are less than 1 percent of Amway's 360,000 distributors. Initial Decision, p. 50, Finding 133. Thus the claims of incomes of $100 to $1,000 per month and the use of the $200 figure in such a way as to imply that it is a typical monthly retail sales figure, constitute misstatements of the amount of money a distributor is likely to earn. The $200 Business Volume figure

[26] "What impression is made by a given practice is a question of fact for the Commission to determine . . . ." *Benrus Watch Co.* v. *FTC,* 352, F.2d 313, 318 (8th Cir. 1965), *cert. denied,* 384 U.S. 939 (1966); *accord Niresk Industries, Inc.* v. *FTC,* 278 F.2d 337, 342 (7th Cir.), *cert. denied,* 364 U.S. 883 (1960); *Kalwajtys* v. *FTC,* 237 F.2d 654, 656 (7th Cir. 1956), *cert. denied,* 352 U.S. 1025 (1957).

[27] We note that this figure is not "retail sales", but Business Volume — that is, the retail value of the products purchased for resale to consumers and sponsored distributors, and for distributor home consumption, which was stated before, constitutes a large portion of all sales of Amway products. *See* Initial Decision, pp. 55–56, Finding 137.

overstates the true average Business Volume by more than 500 percent.[28] And the often unqualified claims regarding actual income are even more removed from reality, at least as reality exists for the vast majority of Amway distributors.

The Commission previously addressed issues concerning unrepresentative earnings claims in *National Dynamics Corp.*, 82 F.T.C. 488 (1973), *aff'd in part and rev'd. in part*, 492 F.2d 1333 (2d Cir.), *cert. denied*, 419 U.S. 993 (1974). In *National Dynamics*, respondents were manufacturers of a battery additive which they marketed through 12,000 distributors. In attempting to recruit new distributors, respondents made generalized earnings claims like, "You can earn $12,000 a year. . . .", and "What do you want to make of your life? . . . An income of $15,000 to $50,000 per year?" They also quoted the following earnings for named individuals: "$1,554 one week", "$148 one day", "$2,316.96 one week", "$1,028 one month". The Commission opinion noted that of the 12,000 [29] distributors selling for respondents in 1969, not more than sixty, or one-half of 1 percent of the total number of distributors, made profits in excess of $10,000. *Id.* at 563. Based on this fact, the Commission found the generalized earnings claims to be misleading and deceptive because they "far exceed[ed] the earnings normally received by dealers." *Id.* at 565. The specific earnings claims for named individuals were also found to be misleading and deceptive because they had "the capacity and tendency to lead members of the public to believe that a substantial number of distributors will regularly earn such amounts." *Id.* at 564.

Amway's specific earnings and sales claims are similar to the claims in *National Dynamics*:[29] they far exceed the amounts normally received by distributors, and, in their cumulative impact, they have the capacity and tendency to lead potential distributors to believe that a substantial number of distributors really do receive such amounts. Therefore, they constitute illegal misrepresentations under Section 5.[30]

Finally, the ALJ found, contrary to complaint counsel's charges, that Amway has not misrepresented distributors' recruiting poten-

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[28] In a speech given to Direct Distributors in 1974, DeVos stated that the reason for using a figure as large as $200 is to raise distributors' "vision" of their own potential. *See* Initial Decision, p. 55, Finding 136. But this does not change the fact that the $200 figure overstates the true average Business Volume amount; and a statement need not be intended to deceive in order to have the capacity to deceive.

[29] It should be noted, though, that Amway has not advertised specific earnings of named individuals. In fact, the 1975 Amway Career Manual states: "Don't quote dollar incomes on specific individuals even though you may want to use their stories about the homes in which they live, the cars they drive, or the airplanes they fly."

[30] We note here that complaint counsel have attacked earnings claims made to potential distributors and to persons who already were Amway distributors. We restrict our finding of a violation to those earnings misrepresentations made to potential distributors. We believe that experienced distributors can be expected to be aware of the opportunities, or lack of opportunities, open to them under the Amway Plan. Statements of the kind discussed in the Initial Decision, at p. 49, Finding 132, when made to persons who already are distributors, can be considered "inspirational" in nature.

tial, and that it has not failed to disclose that distributors incur expenses in operating their distributorship, or that there has been a high rate of turnover among newly recruited distributors. *See* Initial Decision, p. 57, Findings 140–41. We affirm this finding. [30]

III. Procedural Issues

Respondents claim that numerous procedural errors and irregularities occurred, to their prejudice, during this proceeding and the investigation which preceded it. First, they claim that no cease and desist order can be entered against them because part or all of the evidence supporting the complaint may have been acquired by unlawful means. Respondents moved to dismiss the complaint on the same grounds in April 1975. The Commission denied that motion but stated that its ruling was without prejudice to any attempts by respondents to move the ALJ to suppress evidence they claim was improperly obtained. The ALJ thereafter took steps to monitor the source of witnesses and exhibits complaint counsel proposed to call or introduce at the hearings. We find, upon review, that the steps taken by the ALJ were adequate and effective.

Next, respondents claim they were prejudiced by the ALJ's denial of their request for discovery from the files in *Colgate-Palmolive, et al.*, Commission File No. 741–0048 (relating to a non-public FTC investigation). Respondents argue that the discovery sought from that file relates to entry barriers and concentration in the soap and detergent industry, and that it could provide proof of the reasonableness of the vertical restrictions in the Amway Plan. We reject respondents' argument that they were entitled to discovery from this file and affirm the ALJ's order denying discovery.[31]

Respondents further state that a series of procedural errors and irregularities are set forth in a motion to dismiss read into the record on the first day of trial. Though that motion was denied by the ALJ in a June 15, 1978 Order, respondents state that they continue to assert the positions set forth in the motion. Without describing the alleged errors and irregularities, they add: "The bases for those positions are set forth in respondents' motion and do not require repetition here." We have considered the motion set forth in the transcript, and we affirm the ALJ's decision to deny. [31]

Finally, respondents assert that the transcript of testimony given at the hearings is full of errors, and that the record must either be

[31] We note that all of the vertical restrictions challenged have been found to be reasonable, except as they were ancillary to Amway's illegal resale price maintenance plan. We also note that these findings were based on our view that the product markets in which Amway competes are indeed concentrated, and that Amway's presence has had some procompetitive consequences.

reopened to allow correction of these errors or the complaint must be dismissed. Respondents filed a veritable blizzard of papers on this matter with the ALJ, who issued more than ten Orders in response. A brief description of the events leading to respondents' objection is appropriate.

Soon after the hearings ended, respondents objected to about 2000 pages of the transcript, claiming they contained errors. Complaint counsel objected to additional pages, and the parties filed with the ALJ a stipulation of corrections involving over 2000 pages of the transcript. In Orders issued on December 6 and December 30, 1977, and January 6, 1978, the ALJ noted that almost all these stipulated changes involved typographical or spelling errors, and ordered the parties to specify the errors affecting substance. This was to insure compliance with Section 3.44(b) of the FTC Rules of Practice, which says that "[c]orrections of the official transcript may be made only when they involve errors affecting substance . . . ." After considerable maneuvering by the parties with respect to what constitutes an error of substance, the ALJ issued an order on January 24, 1978 stating:

> Respondents submit that there should be changes made on almost 2000 pages of the transcript in this case . . . . Respondents argue that errors in spelling of some of the key words in the transcript must be corrected for the purpose of accuracy in their computer retrieval system. This is a convincing argument. I therefore hold that the pages of the transcript enclosed with this order shall be corrected by the official reporter pursuant to Rule 3.44(b).

By letter of March 13, 1978, the official reporter responded, stating that all the requested changes had been made and characterizing them as "errors in spelling" and "changes in grammer or syntax, post-hearing selections of synonyms deemed more appropriate, expressions of parentheticals in the form of commas, and in some instances complete changes in the sentence structure which reflects the desire of witnesses, after the fact, to communicate their thoughts in clearer fashion." [32]

Still not satisfied, respondents moved, during an oral argument on the merits of the case, to dismiss the complaint on the grounds that not all the ordered corrections had been accomplished.[32] In reply, complaint counsel informed the ALJ that they had learned from the official reporter that no one had arranged to have the transcript put into computer readable form such that it could be utilized in a computerized information retrieval service. This led the ALJ to remark, in his June 15, 1978 Order denying the motion to dismiss,

[32] Respondents assert on appeal that ordered corrections have still not been made on 350 pages, and that there are 35 "garbled or omitted portions of the transcript".

that the 2000 pages previously ordered corrected "need not, therefore, have been retyped pursuant to Rule 3.44(b)." The ALJ continued: "[R]espondents have not been able to point to one proposed finding which might be affected by any of the errors in the transcript they allege." The ALJ noted that the parties were in agreement as to every correction ordered, and therefore instructed complaint counsel to have the stipulation of changes — which consists of hand corrected copies of the transcript pages in question — inserted in the record. Complaint counsel did so, and the hand-marked pages are included in the record as "ALJ Exhibit A". We interpret the ALJ's statement above — that none of the remaining "errors" affects any proposed finding — to mean that none of those errors affect substance. Therefore, no further corrections of the record need be made (if, indeed, any ever did need to be made).

IV. Conclusions

We conclude that respondents have agreed and combined with each other and/or with Amway distributors to fix the resale prices of Amway products, at both the wholesale and retail levels, in violation of Section 5 of the Federal Trade Commission Act. Respondents have also made earnings and sales claims which have the capacity to deceive the potential distributors to whom they have been made; this too, is in violation of Section 5. We have decided that it is appropriate and necessary to order respondents to cease and desist from these violations, and from certain offenses reasonably related to them.

The Commission has also concluded that complaint counsel have failed to establish that respondents have engaged in the other alleged violations of Section 5. Therefore those charges against respondents are dismissed.

FINAL ORDER

This matter having been heard by the Commission upon the cross-appeals of respondents and complaint counsel from the Initial Decision, and upon briefs and oral argument in support thereof and opposition thereto, and the Commission for the reasons stated in the accompanying Opinion having determined to affirm in part and reverse in part the Initial Decision:

It is ordered, That the Initial Decision of the administrative law judge be adopted as the Findings of Fact and Conclusions of Law of the Commission, except to the extent inconsistent with the accompanying Opinion.

Other Findings of Fact and Conclusions of Law of the Commission are contained in the accompanying Opinion.

It is further ordered, That the following Order to Cease and Desist be, and it hereby is entered: [2]

I

It is ordered, That respondents Amway Corporation and Amway Distributors Association, and their officers, agents, employees, representatives, members, successors and assigns, and respondents Jay VanAndel and Richard M. DeVos, individually, and their agents, employees, and representatives, directly or indirectly through any corporate or other device, in connection with the offering for sale, sale, or distribution of cleaning or personal care products, or any other products or goods in commerce, as "commerce" is defined in the Federal Trade Commission Act, shall forthwith cease and desist from:

1. Fixing, establishing, or maintaining, or attempting to fix, establish, or maintain, the price at which any distributor sells or offers for sale any product at wholesale or retail.
2. Stating that distributors are required to, or do, charge a particular price in wholesale or retail sales of any product.
3. Entering into any contract, agreement, understanding, or arrangement with any distributor which fixes, establishes, or maintains the price at which that distributor sells or offers for sale any product at wholesale or retail.
4. Taking any action, or counseling any distributor to take any action, designed to detect the price at which any distributor sells or offers for sale any product at wholesale or retail, including but not limited to: requiring distributors, in proving that they made retail sales to ten different persons in a month, to disclose the price at which they made such sales; directing or requesting any distributor to report to his Direct Distributor, to Amway, or to any other person or entity, knowledge he or she has of another distributor selling products at a price different from Amway's suggested wholesale or retail price; or allowing the price information submitted by any distributor seeking a full or partial refund of amounts paid by him or her for state retail sales tax, to be seen by any person other than those responsible for paying out such refunds, or to be used for any purpose other than paying out such refunds.

Provided, however, it shall not be a violation of this order for Amway to receive information about the price a distributor charged in a particular retail sale if such information is received by Amway solely as a result of such [3] sale being one of the following types: (1)

a sale wherein the purchaser used a bank credit card in making the purchase; (2) a sale of catalog merchandise wherein the purchaser paid by personal check payable to Amway; or (3) a sale to a commercial account wherein Amway financed the purchase.

5. Taking any action, or counseling any distributor to take any action, designed to deter distributors from selling or offering for sale products at a price different from Amway's suggested wholesale or retail prices, including but not limited to: addressing communications regarding price to any individual distributor, rather than to distributors as a class; delaying, or threatening to delay, the shipment of products to any distributor; withholding, or threatening to withhold, any distributor's Performance Bonus, if such distributor is otherwise entitled to such Bonus; underselling, or threatening to undersell, any distributor in retaliation for such distributor having sold or offered to sell products at a price different from Amway's suggested wholesale or retail prices.

6. Preventing or discouraging, or attempting to prevent or discourage, any distributor from selling or offering for sale products at retail to any person or entity, on the grounds that such person or entity is the customer of another distributor.

7. Requiring a distributor who is terminating his relationship with Amway to sell his remaining products back to Amway or to another distributor; *provided, however,* it shall not be a violation of this order to give a distributor who is terminating his relationship with Amway the opportunity to sell his remaining products back to Amway or another distributor.

8. Preventing, or attempting to prevent, a fund raising organization from selling or offering for sale products at a price different from Amway's suggested retail price.

9. Preventing, or attempting to prevent, distributors from advertising the prices at which they are selling or offering for sale products, including but not limited to, failing to include a place for distributors to disclose price in any existing or future sales aids, promotional literature, advertising mats, advertising scripts, etc., used by distributors in advertising Amway products. [4]

10. Publishing or distributing, directly or indirectly, any wholesale or retail price list, order form, promotional material, or any other document which lists resale prices for products without stating clearly and conspicuously thereon: "The prices stated here are suggested prices only. Distributors are not obligated to charge these prices. Each distributor is entitled to determine independently the prices at which products may be sold to other distributors or to consumers."

II

It is further ordered, That the aforesaid respondents and their officers, agents, employees, representatives, members, successors, and assigns, directly or indirectly, in connection with inducing or seeking to induce the participation of any person in any distribution, sales, or marketing plan, in commerce, as "commerce" is defined in the Federal Trade Commission Act, do forthwith cease and desist from:

1. Misrepresenting in any manner the past, present, or future profits, earnings, or sales from such participation.
2. Representing, by implication, by use of hypothetical examples, or otherwise, that distributors earn or achieve from such participation any stated amount of profits, earnings, or sales in excess of the average profits, earnings, or sales of all distributors in any recent year respondents may select, unless in conjunction therewith such average profits, earnings, or sales is clearly and conspicuously disclosed, or the percent of all distributors who actually achieved such stated profits, earnings, or sales in such year is clearly and conspicuously disclosed.

III

It is further ordered, That respondent Amway Corporation or its officers, agents, representatives, employees, successors or assigns shall, within thirty (30) days from the effective date of this order, deliver a copy of this order to all persons who are currently Amway distributors.

IV

It is further ordered, That respondents and their successors and assigns notify the Commission at least thirty (30) days prior to any proposed change in the corporate respondents such as dissolution, assignment or sale resulting in the emergence of successor corporations, the creation or dissolution of subsidiaries, or any other change in the corporations or in the Amway Sales and Marketing Plan which may affect compliance obligations arising out of the order. [5]

V

It is further ordered, That the respondents herein shall within sixty (60) days from the effective date of this order, file with the Commission a report in writing setting forth in detail the manner and form in which they have complied with this order.

EXHIBIT 5

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

FEDERAL TRADE COMMISSION, Plaintiff, v. BURNLOUNGE, INC., et al., Defendants.	)))))))))))	No. CV 07-3654-GW(FMOx) **STATEMENT OF DECISION**

FEDERAL TRADE COMMISSION v. BURNLOUNGE, INC. et al., Case No. 07-3654
STATEMENT OF DECISION

Plaintiff Federal Trade Commission ("FTC") brought this action claiming that Defendants BurnLounge, Inc. ("BurnLounge"), its Chief Executive Officer and Chairman - Juan Alexander Arnold ("Arnold"), and independent retailers John Taylor ("Taylor") and Rob DeBoer ("DeBoer") violated Section 5(a) of the Federal Trade Commission Act ("FTC Act"), 15 U.S.C. § 45(a), by promoting a pyramid scheme,[1] making deceptive income claims, and failing to disclose (when soliciting consumers to participate in the BurnLounge program) that participants were not likely to earn any substantial income. The matter proceeded to a bench trial on December 9, 2008, which concluded on December 22, 2008. During the trial, the Court received live and deposition testimony of 28 witnesses, including Defendants Arnold, DeBoer, and Taylor, and three expert witnesses. Following the trial, the Court requested and received supplemental briefs. After carefully considering the testimony of the witnesses, the joint stipulations of fact by the parties, the exhibits introduced into evidence, the pre- and post-trial written submissions of the parties, and the oral arguments of counsel, the Court issues the following Statement of Decision.

I. FINDINGS OF FACTS

(a) Venue and Jurisdiction

Venue in this District is proper pursuant to Section 13(b) of the FTC Act (15 U.S.C. § 53(b)) and 28 U.S.C. § 1391. All Defendants do not reside in the same judicial district, but a substantial portion of the events giving rise to the claimed violations have occurred in the Central District of California. Defendant BurnLounge promoted, recruited, sold, and operated its business in the Central District. Declaration ("Decl.") of Bruce Gale, Trial Exhibit ("Ex.") 347, ¶¶ 2-7, 9; Exs. 1-3 & 8, § 7.1.2; Decl. of Michael Liggins, Ex. 337, ¶ 8; Decl. of Michael Marino, Ex. 349, ¶ 5; Ex. 33, p. 21; Decl. of Roberto Menjivar, Ex. 351, ¶¶ 2, 7; Ex. 37, pp. 45, 53. BurnLounge also operated a customer service office in Rancho Santa Margarita, California. See Transcript of the Trial Testimony ("Tr.") of Bernard Rivera, Day 2 PM at 14:11-23;[2] Ex. 242, p. 3. In addition, Arnold (BurnLounge's CEO) resides in this District. See Final Pretrial Conference Order (Proposed) ("FPO"), Stip. 5(e) at page 3, Docket Item Number ("Doc. No.") 353-2; Arnold Tr. Day 3 PM at 136:23-24.

[1] "Pyramid" or "pyramid scheme" are often used in the vernacular to refer generally to a multi-level marketing organization, whether legal or illegal. For purposes of this opinion, "pyramid" will only refer to the latter.

[2] The Reporter's Transcript of trial testimony is divided into Days 1 through 9, representing the periods of December 9-12, 15-18, and 22 of 2008 respectively. Most of the transcripts for each day are designated as either "AM" or "PM" sessions. Hence, references to trial testimony herein will be made as follows: "[name of witness] Tr. Day [#] [AM or PM, where applicable] at [page number: line numbers]." For example, a citation to "Arnold Tr. Day 3 PM at 136:23-24" would refer to Arnold's testimony which was given in the afternoon session of the third day of the trial which occurred on December 11, 2008, and indicates that the cited testimony can be found in the Reporter's Transcript for that date on page 136 at lines 23 and 24.

(b) The Parties

Plaintiff FTC is an independent agency of the United States created by the FTC Act. 15 U.S.C. § 41. The FTC is charged with enforcement of Section 5(a) of the FTC Act, 15 U.S.C. § 45(a), which prohibits unfair and deceptive acts and practices in and affecting commerce. FPO, Stip. 5(a)-(b).

Defendant BurnLounge is a Delaware corporation that began making sales in late 2005. FPO, Stip. 5(c)-(d). BurnLounge had net revenues as follows: $2,158,027 in 2005, $19,158,872 in 2006, and $6,830,764 in the first six months of 2007. Exs. 64, 66. More than 60,000 people paid to participate in the BurnLounge enterprise. Ex. 1051.

Defendants Arnold, Taylor, and DeBoer all promoted the BurnLounge business opportunity. DeBoer Tr. Day 3 PM at 34:17-35:25; Taylor Tr. Day 2 PM at 125:11-126:19; Arnold Tr. Day 4 AM at 61:25-62:21.

Defendant Arnold is and was the CEO and Chairman of the Board of Directors of BurnLounge. FPO, Stip. 5(c)-(d). During his tenure, he earned $593,732.01 in salary and bonuses. Richard Piemonte Tr. Day 8 at 139:15-143:17. He also received reimbursements for certain business expenses. FPO, Stip. 5(h). Arnold beneficially owned 43.7 percent of the voting stock of BurnLounge. Ex. 242, p. 47; see also Ex. 242, p. 31. BurnLounge was the brainchild of Arnold (Arnold Tr. Day 3 PM at 142:25-143:5), and he was its "boss" and "ultimate authority." Stephen Murray Tr. Day 6 PM at 41:15-19; Arnold Tr. Day 4 AM at 12:3-15.

Defendant Taylor is a resident of Houston, Texas. John Taylor Tr. Day 2 PM at 120: 17-19; FPO, Stip. 5(j). He was a BurnLounge "VIP Mogul" (which is defined in subsections (d), (c) and (h), infra). Taylor Tr. Day 2 PM at 124:9-10. He held the first position in the binary structure of BurnLounge's compensation plan and sometimes referred to himself as "Retailer 001." Id. Day 2 PM at 124:11-20; see also Ex. 330 at page 2 marked as D0016447. Taylor's income from BurnLounge totaled $620,139.64. Id. Day 2 at 152:17-21; Ex. 191. He was not an employee or an officer of the company.[3] Taylor had participated along with Arnold in various "network marketing" companies between 1995 and 2004. Id. Day 2 PM at 121:7-122:21. Taylor also assisted in raising capital funds for BurnLounge and owned stock and stock options in the company. Id. Day 2 PM at 123:18-124:8.

Defendant DeBoer is a resident of Irmo, South Carolina. DeBoer Tr. Day 3 PM at 29:7-8; FPO, Stip. 5(j). He first became involved with BurnLounge on a part-time basis in October of 2005.[4] Id. Day 3 PM at 34:17-21 and 93:8-24; FPO, Stip. 5(k). He had no prior dealings with either Arnold or Taylor. He did not leave his prior employment with a sports equipment marketing company associated with the University of South Carolina and begin working full-time as a BurnLounge independent retailer until March of 2006. Id. Day 3 PM at 29:12-15, 95:4-6. His earned income from BurnLounge totaled $908,293.69. Id. Day 3 PM at 37:4-10. He was not an employee, officer, decision maker or shareholder of the company. Id. Day 3 PM at 95:12-24. Although he did attend and give presentations at some BurnLounge events across the country, he made his own

[3] However, at some BurnLounge promotional presentations, Taylor was introduced to prospective retailers as "Mr. Arnold's right-hand man." Taylor Tr. Day 3 AM at 22:13-16.

[4] According to BurnLounge's records, DeBoer was the 325th person to join the program. See Ex. 330 at page marked as D0017456.

arrangements and paid his own expenses. Id. Day 3 PM at 96:3-14.

(c) The BurnLounge Concept

BurnLounge was allegedly envisioned as a retailer of digital content designed to integrate music downloads, social networking, and entrepreneurship through the creation of multiple, customized, online purchase points. See Ex. 1 at 20 ("What we're doing at BurnLounge [is] combining . . . the digital downloads of iTunes, the entrepreneurship of eBay, and the connectivity, the social networking of . . . MySpace."). The company licensed music from the five major record labels through an agreement with LoudEye and (later) Muze.[5] Murray Tr. Day 6 AM at 120:18-121:2, 150:12-151:3, Day 6 PM at 93:21-94:17; Ryan Dadd Tr. Day 7 at 5:19-8:9, 12:20-13:13, 111:15-18. This license accounted for a myriad of major and independent recording label artists' songs, which BurnLounge customers could purchase typically for $0.99 per song or $9.90 per album. (But see footnote 11, infra). Marie Jimenez Tr. Day 7 at 158:4-7; see also Ex. 8, § 6.2.2. Before this action was filed, BurnLounge purportedly had agreements in place to add movies, advertising, and other digital content to its offerings; but supposedly due to the present dispute, none of these items were ever actually in place to be sold at retail. Murray Tr. Day 6 PM at 7:12-8:10, 50:14-52:3; Dadd Tr. Day 7 at 83:16-84:20.

Defendants marketed BurnLounge as a "Multi-Level Marketing" ("MLM") business opportunity from September 2005 through June 2007, when this action was filed. Ex. 330. They recruited participants to the program by selling "turn-key" (i.e. ready to begin operating) websites which allowed users to customize their own online music store by choosing the layout, appearance, and featured music. See section 1.2 of BurnLounge, Inc.: Statement of Policies and Procedures ("BurnLounge Policies") which was admitted at trial as Exhibit 8; Bernie Rivera Tr. Day 2 PM at 58:23-59:18; Taylor Tr. Day 2 PM at 153:14-154:2. Purchasing a website was one of the prerequisites to become a BurnLounge Retailer (i.e. one who could earn the equivalent of non-cash credits towards the purchase of BurnLounge's products and services) or a "Mogul" (i.e. one who had the right to possibly earn monetary commissions from BurnLounge). Ex. 8 § 2.2-2.2.1. During the time BurnLounge was in operation, 60,269 people joined the enterprise as "Moguls." Ex. 331.

(d) The BurnLounge System

BurnLounge created a network of web pages ("BurnPages")[6] for the sale of digital music downloads and other products. See Ex. 8 § 1.2. To sell its music, BurnLounge made exclusive use of independent BurnLounge "Retailers" who managed their own BurnPages, selected music to feature and otherwise customized the appearance of their sites. Rivera Tr. Day 2 PM at 58:23-59:18; Taylor Tr. Day 2 PM at 153:14-154:2; see

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[5] LoudEye was a company that facilitated the licensing of music for BurnLounge and "ingested" (i.e., made music available to) BurnLounge's catalog, supposedly as it became released. See Stephen Murray Tr. Day 6 PM at 34:1-18, 93:21-94:11, 149:5-151:3. LoudEye was later sold to Muze, which performed essentially the same function. Id. Day 6 PM at 33:15-25.

[6] The actual term used in Defendants' materials for these retail sites was "BurnLounges." However, to avoid confusion with "BurnLounge" - the corporation, this Statement of Decision will take the liberty of referencing the sites as "BurnPages."

also Ex. 8 § 1.2. Customers wishing to purchase music from BurnLounge could not purchase it from the company directly, but had to visit the BurnPage of an independent Retailer/Mogul. Ex. 8 § 1.2

Retailers paid a fee of $29.95 per year to operate their BurnPages.[7] Ex. 8 § 2.5; see also DeBoer Tr. Day 3 PM at 84:19-24. In addition to music, Retailers could sell "product packages," which gave purchasers the ability to become Retailers themselves and create their own BurnPages. Ex. 8 §§ 2.1, 2.3. Product packages could not be purchased directly from the company but only through the BurnPages of a sponsoring independent Retailer/Mogul. Id. at § 2.3.

There were three product packages available to customers: "Basic" ($29.95), "Exclusive" ($129.95 plus $8.00 per month), and "VIP" ($429.95 plus $8.00 per month). FPO, Stip. 5(t)-(v). The Basic Package consisted of: 1) a turn-key BurnPage, 2) editing and customization software, 3) access to the BurnLounge resource center, 4) a sample copy of "BurnLounge Magazine," and 5) an annual subscription to "FrontBurner Magazine," which was an online website. FPO Stip. 5(t); Murray Tr. Day 6 PM at 21:4-15. The Exclusive Package added: 1) a year-long subscription to "BurnLounge Presents" which was a monthly bundle of 10 songs selected by BurnLounge and available for download by the Retailer, 2) a monthly DVD featuring mostly independent artists, again selected by BurnLounge's A&R Department, and 3) an annual subscription to "BurnLounge Magazine." FPO Stip 5(u). The VIP Package added: 1) the "Event Pass" which provided for, among other things, front-of-the-line admission and access to VIP lounges at certain concert events, mostly at venues operated by Live Nation such as the "House of Blues" music halls and various amphitheaters (Caroline Burruss Tr. Day 6 PM at 113:11-17, 117:22-118:18), and 2) "BurnLounge University," a boxed set of six educational DVDs documenting the history of the music industry. FPO, Stip. 5(v).

Anyone who operated a BurnPage was designated as a "Retailer" at no additional charge and could sell products through his/her e-commerce website in return for "Burn-Rewards" but could not (without more) participate in the BurnLounge Compensation Plan for cash payments. FPO, Stip. 5(w). To be eligible to participate in the cash portion of the Compensation Plan, the Retailer (in addition to purchasing a Product Package) had to pay a monthly fee of $6.95 whereupon he/she was designated as a "Mogul." Id., Stip. 5(w) and (x).

BurnLounge, in April of 2007 (approximately 6 weeks before the filing of this action), began to offer free BurnPages, which were less sophisticated than those originally offered through the Basic Package, but which did include the ability to sell downloads and earn BurnRewards. Murray Tr. Day 6 AM at 127:23-128:25, Tr. Day 6 PM at 5:9-8:1.

In return for sales of music and product packages, Retailers earned BurnRewards, points which were redeemable to pay for BurnLounge fees, downloadable music, and other merchandise, but which were not equivalent to cash. FPO Stip. 5(w); Ex. 8 §§ 6.1, 6.8. BurnLounge Retailers had the option at any time of choosing to pay the fee to become a "Mogul," which allowed him/her to convert his/her BurnRewards into cash on

[7] There were times when the recurring yearly fees charged to Retailers were not billed as originally planned. For example at one point, BurnLounge temporarily waived the fees in light of technical difficulties the company was experiencing in regards to the downloading of music. Murray Tr. Day 6 PM at 80:4-81:1.

a $1 per point basis, after meeting certain minimum qualifications.[8] FPO Stip 5(w), (x); Ex. 8 §§ 6.1.4-6.1.5. The vast majority of Retailers (approximately 97%) chose to become Moguls for at least part of the time they participated in the BurnLounge enterprise. Ex. 331.

(e) Defendants' Expert's Valuation of the Product Packages

The Defendants' expert, David Nolte ("Nolte"), testified regarding the value of each of the products bundled with the product packages. In estimating these values, Nolte employed a "market approach" commonly used in real estate appraisals in which value is determined by comparable products in the marketplace. Nolte Tr. Day 8 at 179:24-180:7, 180:20-181:13. The FTC makes no attempt to place a value on the bundled products, although it is critical of the methods employed by Nolte.[9] The Court shares many of the FTC's criticisms as delineated below.

***(i)* The Basic Package**

As noted above, the Basic Package included the BurnPage, editing and customization software, a resource center, an issue of the BurnLounge Magazine, and an annual subscription to the FrontBurner Magazine website. In assessing the value of the BurnPage, Nolte compared the costs of purportedly similar operations available from two other websites (i.e., PayPal and Amazon) which offer online retail store opportunities. Nolte Tr. Day 8 at 182:12-24. According to his report, PayPal charges $360 per year to operate an online store, and Amazon charges around $480 per year. Nolte Tr. Day 8 at 183:20-184:1. In his assessment, Nolte ignored the vast differences between those business operations - such as the facts that BurnLounge provided the content for the BurnPages;[10] that content was extremely limited (i.e., for most of the relevant time herein, it was music downloads which were available through a plethora of competing, already established legitimate vendors such as iTunes and Amazon.com, as well as a large number of illegal "free" music download cites);[11] Amazon and PayPal are established commercial enterprises with histories of reliable performance and well-executed economic models as opposed to BurnLounge's untested technology and its byzantine business scheme;[12] etc. See e.g. Nolte Tr. Day 8 at 182:12-183:6. Nolte

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[8] A BurnLounge Retailer had to be "at least 13 years of age." Ex. 8, § 2.1. BurnLounge Moguls had to be "at least 18 years of age" and "have a valid Social Security or Federal Tax ID number . . . ." *Id.* at § 2.2.

[9] As noted by the FTC's expert witness, it is virtually impossible to place a reasonable value on products bundled into the BurnLounge Packages where they are not available separately to consumers and, hence, there is no basis to calculate or estimate any independent demand (i.e. market) or inherent worth for those items. Peter Vander Nat Tr. Day 5 PM at 30:2-31:8.

[10] Nolte opined that it was an "advantage" that BurnLounge provided content for its stores. Nolte Tr. Day 8 at 182:16-21. There was an dearth of convincing evidence to support that opinion.

[11] There was also evidence that the scope of available music downloads on the BurnLounge system was limited. For example, there was testimony that BurnLounge did not have immediately accessible most of the "top 10" or "top 40" selling weekly songs and albums. See e.g. Marshall Becker Tr. Day 2 PM at 72:3-10 and 77:3-21; Steven Bowers Tr. Day 2 AM at 10:25-11:10.

[12] There was testimony that BurnLounge's operations had periodic system failures and glitches.

concluded that the BurnPage and its related software were worth approximately $400. Nolte Tr. Day 8 at 184:2-10. This Court finds that opinion not credible and unsupported by the evidence.

BurnLounge Magazine was a music-related publication which was issued (at different times) on a quarterly or monthly basis. Nolte Tr. Day 8 at 186:16-19; Ex. 1063. The magazine was printed in full-color on heavy stock. Id. Day 8 at 186:23-24. After citing to "Future Music," "Cinefex," "Billboard," "Mix," "Vibe," and "Down Beat" as comparable periodicals, Nolte concluded that BurnLounge Magazine had a value of $5 per issue. Id. Day 8 at 187:4-188:23. Again, this Court finds the comparisons to be inapt and without convincing supportive evidence. The publications referenced have a record of sales over many years and their continued existence in the market demonstrates some value. BurnLounge Magazine had no such record nor any indication that anyone would pay money for an issue if it were not already tied to the BurnLounge scheme. Similarly, there was insufficient evidence that the costs of producing an issue of BurnLounge Magazine was similar to those of the cited periodicals. Finally, the customer only received one sample copy with the Basic Package.

***(ii)* The Exclusive Package**

The Exclusive Package contained everything in the Basic Package plus a full year subscription to both BurnLounge Magazine and BurnLounge Presents. The lack of demonstrable value of the BurnLounge Magazine has already been discussed above.

BurnLounge Presents was a subscription to receive 10 music downloads and a music DVD every month. Nolte Tr. Day 8 at 190:1-19; 193:12-16. To estimate a value for the music download portion, Nolte compared three music/movie clubs in which the items sold were preselected by the seller: "Echo Disk," "Independent Disk," and "Film Movement" (an independent film gift-of-the-month club). Nolte Tr. Day 8 at 190:23-191:19. These subscriptions ranged from $160 per year to $190 per year, but Nolte paid more attention to the discount that occurred as a result of having the seller make the product selection. Nolte Tr. Day 8 at 191:20-191-23. Nolte noted that the greatest discount offered by the comparable subscriptions was six percent, which he applied to the price of a song ($0.99) to arrive at a value of approximately $110 for the year's worth of music downloads (120 songs). Nolte Tr. Day 8 at 192:24-193:11.

For the DVD portion of BurnLounge Presents, Nolte identified various music DVDs available for between $12 and $20. David Nolte Tr. Day 8 at 193:12-194:11. He estimated that a BurnLounge DVD "can't possibly be lower than [$10]." Nolte Tr. Day 8 at 194:12-18. Nolte concluded from the above that the yearlong subscription to BurnLounge Presents was worth at least $230 per year. Nolte Tr. Day 8 at 194:19-22.

Nolte's analysis of the values for the downloads and DVD portion of BurnLounge Presents is defective. Providing customers with downloads and DVDs of music (which they have not indicated any desire to receive) is hardly worth the $340 per year that Nolte invents. At best, BurnLounge Presents is merely a means by which the customers can be exposed to music/recording artists with which they might not be familiar. However, this Court notes that persons with access to the internet (which obviously BurnLounge Retailers would have) can listen to music/recording artists for free through such venues as Pandora, YouTube and preview samplings on websites such as Amazon.com. While, ultimately, this Court would not find that BurnLounge Presents had absolutely no value, it would conclude that Nolte's valuation of $340 is grossly excessive and without adequate credible evidence.

(iii) The VIP Package

The VIP Package contained everything in the Basic and Exclusive Packages plus the BurnLounge University DVD set and the LiveNation Event Pass.

BurnLounge University contained six educational DVDs documenting the history of the music industry. Nolte Tr. Day 8 at 195:5-20; FPO Stip. 5(v). Nolte compared BurnLounge University to other educational products (using the term loosely) more or less related to the music industry. Nolte Tr. Day 8 at 195:24-196:7. The products ranged from a two-and-a-half hour seminar that cost $75 to a music industry conference held in Atlanta for $250. See Nolte Tr. Day 8 at 196:15-198:3. Ultimately, Nolte concluded that BurnLounge University is worth around $150. Nolte Tr. Day 8 at 198:4-7. Burn-Lounge's policies and procedures offered a refund of $125 for the DVDs if returned unopened within 12 months of purchase. Nolte Tr. Day 8 at 198:8-14; Ex. 8 § 7.1.2. Evidence was presented that used copies of BurnLounge University were available online at Amazon.com for as little as $9.87. See Ex. 438.

The Event Pass allowed BurnLounge Retailers early entry into various clubs and amphitheaters as well as access to the VIP Lounge at many events. Caroline Burruss Tr. Day 6 PM at 118:1-18, 119:16-120:3; Nolte Tr. Day 9 AM at 8:13-23. Early admission saved concert-goers time that otherwise would have been spent in line hoping for a good seat, but obviously was only useful where the event did not have assigned seating. Caroline Burruss Tr. day 6 PM at 120:15-121:2, 122:10-19. VIP Lounge access was normally limited to season-ticket or box-seat holders who would pay between $1,250 per seat for a season ticket and $5,000 per seat per season for a box seat. Caroline Burruss Tr. day 6 PM at 120:4-14, 123:15-17. Nolte started his valuation of the Event Pass by noting that Live Nation charged between $45 and $65 for its "passes" at amphitheaters.[13] Nolte Tr. Day 9 at 8:24-9:10. He then looked at the difference between VIP lounge access and non-access for the same types of seats and concluded that it was between $90 and $175 per show. Nolte Tr. Day 9 AM at 9:11-22. Nolte concluded that the pass would have a value of around $200, noting that its value to an individual would really depend on the number of shows he/she attended per year. Nolte Tr. Day 9 AM at 9:23-10:12. Defendants presented no evidence as to how many of the VIP Package purchasers lived in an area which even had a nearby or otherwise accessible club or amphitheater where the Event Pass could be utilized.

(f) The Value of the Product Packages

Defendants argue that they have provided "overwhelming" evidence that the products bundled into the product packages were worth more than what BurnLounge charged for them. See Amended Final Post-Trial Brief of Defendants BurnLounge, Inc. and Juan Alexander Arnold at 10, Doc. No. 407. But the evidence was neither overwhelming nor even remotely persuasive.

Nolte's valuation of BurnLounge's products employed a "market approach," that

[13] It appears Nolte may be referring to ticket prices, which are irrelevant as Event Pass holders still had to purchase tickets. See Caroline Burruss Tr. Day 6 PM at 124:5-12. Live Nation did not sell Event Passes aside from those available through BurnLounge. Id. Tr. Day 6 PM at 122:20-123:14.

compared "similar" products in the marketplace such as educational DVDs and music magazines. The problem is that these products had already established themselves and survived in the marketplace. They had a history that reveals that their retail prices were near their actual value - if they were not, the products would not have survived the competition on the shelves.

Defendants note that in Arab Monetary Fund v. JHH Canadian Capital Corp., 356 B.R. 728, 745 (D. Ariz. 2007), a "valuation expert" opined on the value of a piece of real estate based on a review of information on the market and comparable sales. But real estate and consumable entertainment products are not comparable in this sense. Real estate within a given area is of limited supply, is typically somewhat homogenous, and has objectively comparable features such as design, type of construction, number of rooms, square footage, etc. Consumer goods - especially music, DVDs, and magazines - are more prone to the vagaries of individual tastes and fickle consumer trends. Billboard and Vibe magazines have established their value in the marketplace and built a loyal following among consumers who choose those magazines over dozens of competing (and arguably less valuable) periodicals. BurnLounge Magazine, on the other hand, was a little-known, scarcely circulated periodical without even a stable production schedule. See Nolte Tr. Day 8 at 186:11-19.[14] Similarly, there was no evidence that the persons at BurnLounge who selected music for BurnLounge Presents had any "track record" of picking songs that would have any value or use to BurnLounge participants.

Nolte also compared BurnLounge University to a ten-DVD documentary on jazz music by renowned director, Ken Burns, which sold for about $100. Nolte Tr. Day 8 at 197:8-17, Day 9 PM at 22:15-23:9. That comparison makes no sense. BurnLounge University contained only six DVDs, was never made available through the same channels as Burns's film, and was not produced or directed by anyone of any note. In addition, Nolte's focus on the fact that the Burns's DVD set was a "secondary exploitation" as a reason to assume a greater value for BurnLounge University, which was a "primary exploitation," does not make sense. See Nolte Tr. Day 8 at 197:11-13. The Burns's documentary's primary exploitation was on public television and initially free to most consumers; and thereafter made available for purchase to the public after that exposure which helped to create a demand for the work.

Before the FTC filed suit, BurnLounge's products had not been tested in the marketplace absent their being tied into the Retailer/Mogul business opportunity. But once the multi-level business opportunity was removed, sales of the packages plummeted, indicating that the products were worth less than the expert's list of "comparable" products. See Exs. 65, 67, 68 (showing revenues dropped from $476,516 in June 2007 to $15,270 in July to $10,880 in August). It is also likely that this sudden drop in package sales is explained as well by the sudden drop in the number of

[14] In addition, Nolte considered the costs of production and the fact that BurnLounge Magazine contained very little advertising. David Nolte Tr. Day 8 at 189:7-13. But cost is irrelevant to consumer value absent any evidence of concomitant consumer demand. The lack of advertising, while it may add marginal value for some readers, speaks more to cost. See Defendants' Final Post-Trial Brief at 11 n. 18 ("BurnLounge Magazine contained no such advertisements [as other magazines do] and so could not rely upon advertising revenues so as to provide a discounted subscription rate."). The lack of advertising demonstrates that BurnLounge would be forced to charge a higher price for a subscription to its magazine, but not whether enough people would be willing to actually pay that price. Only the latter is an indication of value.

salespeople actively selling packages and/or by the publicity surrounding the filing of this lawsuit.

Value, of course, is subjective. One man's trash is another man's treasure. Accordingly, value is not actually a fixed quantity, but slides along a demand curve. The fact that the products contained in a VIP package might be worth at least $400 to one person is not dispositive of whether they are worth anything near that much to 50,000 other people. Nor is it initially necessary for the Court to decide whether BurnLounge charged more than its products were worth (although, in the end, the Court finds that it did for the vast majority of Exclusive and VIP package purchasers). The initial question is whether the products had so little value as to be a complete sham, and the Court finds that they did not.[15]

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. See Section II(d), infra.

(g) BurnLounge's Compensation Plan/Burn Rewards

An accurate delineation of BurnLounge's "Compensation Plan" for those persons who were enticed into its sales program (i.e. who became BurnLounge Retailers and/or Moguls) is difficult given the degree of complexity in its composition and the failure of its creators to value intelligibility, consistency, and useful definitions.[17] Indeed, it would appear that BurnLounge was attempting to create a labyrinth of obfuscation rather than a readily understood compensation system.[18]

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[15] Paradoxically, the FTC claims that the value of the products is irrelevant because they were all "incidental" to the business opportunity, Plaintiff's Response to Defendant's Proposed Finding of Facts ("PR") at 5, and "part of" the business opportunity, PR at 6.

[16] Were the Court to take on the task of assigning a specific dollar value to the bundled products, it would find them to be worth far less than the amounts BurnLounge charged for them. However, some individuals purchased product packages without participating in the business opportunity. The Court is essentially giving the benefit of the doubt to BurnLounge that the products had at least as much value as the amount being charged *for those people* as evidenced by their purchasing behavior.

[17] For example, section 6.1 of BurnLounge Policies states that "BurnRewards are maintained in an account for each Customer . . . ." Ex. 8 at page 25. However, section 12 defines "end customer" (which is "also referred to as 'customer'" in the Policies) as "a person who is not a BurnLounge Retailer [and] who purchases BurnLounge products and services for personal use and not for resale." Id. at 45; see also Ex. 423. Given that a "customer" is not a BurnLounge Retailer, a customer could not earn or utilize Burn-Rewards and, hence, there would be no readily discernable purpose in maintaining a BurnRewards account for that person.

[18] There was testimony at trial that legal counsel had been involved in the drafting of the BurnLounge compensation program. See e.g. Taylor Tr. Day 3 AM at 21:5-14. However, during the course of the litigation, Defendants asserted the attorney-client privilege and indicated that they were not raising a

Everything earned by BurnLounge's Retailers and Moguls through their sales and recruitment efforts was paid in "BurnRewards," which was described as being the "currency" of BurnLounge. Ex. 8 § 6.8. BurnRewards were maintained in an account for each Retailer and Mogul. Id. Retailers could not redeem their BurnRewards for cash, but could exchange them for BurnLounge products and services, where one BurnReward Point was equivalent to one dollar. Id. "Qualified" Moguls could redeem their Burn-Reward Points for cash. Id.

BurnRewards could be earned through sales of music and product packages, or users could fund their BurnRewards account with their credit cards. Ex. 8 §§ 6.8-6.8.1. There were two types of BurnRewards Points: "Product Points" and "Cash Points." Id. § 6.8-6.8.2. Retailers earned Product Points off of sales made through their own Burn-Pages while Moguls earned Cash Points for the same. Id. § 6.8.2. Unlike Product Points, which lapse after 1 year, Cash Points never expired and were readily redeemable for their equivalent dollar value (1 point = $1). Id. §§ 6.8.2, 6.8.5. Points purchased by credit card were always Cash Points. Id. § 6.8.1. There were processing fees of three dollars for each check issued and one dollar for each direct deposit. Id. § 6.8.3.

(h) The Mogul Program

Any Basic, Exclusive, or VIP Retailer could become a Mogul for a fee of $6.95 per month. FPO Stip. 5(w), (x). Moguls had access to the Business Management System ("BMS" or "back office"), where a Mogul could track sales, view his/her "downline" activity, access business cards and posters, see his/her BurnRewards earned, etc. Arnold Tr. Day 4 AM at 29:8-30:2; Taylor Tr. Day 2 PM at 130:1-25; see also Ex. 149.[19]

In order to convert BurnRewards to cash, a Mogul had to become a "Qualified Mogul" by meeting the following prerequisites:

- One-Time Requirements[20]
    - Sell two BurnLounge Exclusive or VIP Packages.
    - Sell at least two albums to non-Moguls.[21]
    - The following additional requirements were imposed in

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defense based upon advice of counsel. Thus, at trial, there was no evidence as to what legal advice the Defendants actually received (if any) and whether they followed it.

[19] BurnLounge contends that individuals may have paid the $6.95 monthly fee for reasons other than to participate in the business opportunity such as to access the "back office." See Defendant's Post Trial Brief ("PTB") at 14 & n. 23. This is supposedly evidenced by the 26,670 individuals who paid the fees but never earned a single penny in BurnRewards. PTB at 14. A more likely explanation for this phenomenon is that these individuals either changed their minds about participating at all or found it too difficult to convince others to make necessary purchases. There is also evidence that BurnLounge Moguls periodically faced technical difficulties which may have made it difficult or impossible for some Moguls to make sales. See e.g. Jerry Baccus Tr. Day 1 PM at 26:9-15; Wayne Bowers Tr. Day 2 AM at 12:14-13:11. Further, it is unclear how access to the "back office" would actually benefit a BurnLounge member who did not intend to engage in the entrepreneurship endeavors promoted by the Defendants.

[20] Exclusive and VIP Moguls who joined prior to June 10, 2006, were exempt from the one-time requirements. Ex. 8 § 6.1.4.

[21] This requirement apparently changed shortly before the FTC filed this action to also disqualify sales to Retailers. See Ex. 43 at 1171.

regards to Mogul Bonuses. BurnLounge Basic Moguls had to accumulate $500 worth of Music Sales Volume ("MSV") to receive a $25 Mogul Bonus. Unless Basic Moguls fulfilled that MSV requirement, they receive no Mogul Bonuses. BurnLounge Basic Moguls had to accumulate $1,000 worth of MSV to receive the $50 Mogul Bonus. BurnLounge Exclusive Moguls had to accumulate $500 worth of MSV to receive a $50 Mogul Bonus. Until Exclusive Moguls fulfilled that requirement, they received only the $25 Mogul Bonus. VIP Moguls had no initial hurdles to their being immediately eligible to receive the higher $50 bonus.

- Monthly Requirements
  - Sell two albums in the previous calendar month to non-Moguls.
    - If a Mogul failed to sell the two albums in the previous month, he/she could qualify for the remainder of the current month by selling ten albums, provided he/she had also met the one-time qualification requirements.
- Payment Requirements
  - Maintain a positive BurnRewards account balance. In the event a Mogul's unpaid BurnRewards balance[22] exceeds $15, Moguls cease to be qualified for Mogul Bonuses.

Ex. 8 §§ 6.1.4-5.

(i) Compensation

BurnLounge rewarded Retailers and Moguls for their endeavors in three ways: Concentric Retail Compensation, Product Package Bonuses, and Mogul Team Bonuses.

***(i)* Concentric Retail Compensation**

Concentric Retail rewarded Retailers/Moguls for product sales made through their own BurnPages and those of their downline recruits (if any) in the percentages delineated below. See Ex. 8 § 6.2. Product sales included music purchases, the $8 per month fee for BurnLounge Presents, and the first $29.95 of each Product Package. Ex. 8 § 6.2; Rob DeBoer Tr. Day 3 PM at 84:11-85:7.

Those individuals that a Retailer recruited into BurnLounge (i.e. sold a Product Package via his/her BurnPage) became members of his/her Direct Team, also known as Ring 1. Ex. 423 at 3.[23] Those individuals recruited by his/her Direct Team members

[22] Moguls had various monthly and/or yearly charges which they could pay with BurnRewards or with a credit card. In the event the chosen payment method failed, the other method was used. If both failed. BurnRewards were deducted from the Mogul's account even if that deduction overdrew the account. This made it possible for Moguls to carry a negative or unpaid BurnRewards balance. See Ex. 8 § 6.4.2.

[23] Exhibit 423 was not an official document created by BurnLounge, but it was used by the parties at trial to help explain the workings of the BurnLounge compensation structure.

became his/her Ring 2; those recruited by members of Ring 2 became Ring 3; and so on up to Ring 6. Ex. 423 at 3. After meeting "minimum" music sales requirements [delineated below], a Retailer/Mogul could earn commissions (in the form of Burn-Rewards) off of product sales made by up to six levels of his/her Rings of recruits. Ex. 8 §§ 6.1-6.1.2, 6.2.1. The compensation reward was based on a percentage of Burn-Lounge's gross margin[24] of each product sale as follows:

- Personal Sales 20%
- Direct Team (Ring 1) 12%
- Ring 2 5%
- Ring 3 5%
- Ring 4 5%
- Ring 5 5%
- Ring 6 8%

Ex. 8 § 6.2.1.

In addition, there was a floor set on the commissions paid for music sales. The purchase of a full-priced ($9.90+) album or batch of 10 full-priced ($0.99+) songs from a Retailer's own BurnPage yielded 20% of the gross margin or $0.50, whichever was greater. Ex. 8 § 6.2.2. The purchase of a full-priced ($9.90+) album or batch of 10 full-priced ($0.99+) songs from a BurnPage owned by a member of his/her Direct Team yielded 12% of the gross margin or $0.20, whichever was greater. Id. These music sale guarantees were called the Fifty-Cent Rule and the Twenty-Cent Rule respectively. Id.

(A) Sales Qualifications

There were no sales requirements to receive BurnRewards for product sales on one's own BurnPage. Ex. 8 § 6.1.1. Retailers/Moguls qualified incrementally to earn Concentric Retail BurnRewards from each of their Rings. Ex. 8 § 6.1.2. The qualification to collect compensation from successive rings depended on album sales in the previous month.[25] Ex. 8 § 6.2. To earn a Concentric Retail commission from Ring 1, a Retailer/Mogul must have personally made 4 album sales from his/her BurnPage. In addition, the members of his/her team (which may include himself/herself) must have sold 8 albums (for a total of 12). To earn from Ring 2 required 8 personal sales plus 24 team sales. Ring 3 required 12 personal sales plus 48 team sales. Ring 4 required 16 personal sales plus 48 team sales. Ring 5 required 20 personal sales plus 120 team sales. Ring 6 required 24 personal sales plus 168 team sales. Ex. 8 § 6.1.2; Ex 423 at 3.

In addition, a Retailer/Mogul must have met the one-time requirement to have sold at least one Exclusive or VIP Package (what this opinion will dub a "premium package") for each Ring of Concentric Retail for which he wishes to qualify (e.g. in order to qualify to earn commission off sales by Ring 4, the Retailer must have sold at least 4 premium packages). Ex. 8 § 6.1.2; Ex. 423 at 3.

[24] A review of BurnLounge's printed materials does not reveal any document which either delineates what its "gross margins" are for particular products or which explains how they are calculated. See Peter Vander Nat Tr. Day 4 PM at 110:13-114:9.

[25] Retailers/Moguls were automatically qualified vis-à-vis the prior month's album sales for all six rings for their first month.

Finally, as with the requirements for being a Qualified Mogul, a Retailer/Mogul must have maintained a positive BurnRewards account to qualify for Concentric Retail. Ex. 8 § 6.1.3. If a Retailer's balance (deficit, more accurately) exceeded $15.00, he/she ceased to receive BurnRewards on the sales of his/her downline. Ex. 8 § 6.1.3.

In some cases, Retailers/Moguls could receive Concentric Retail compensation from others beyond their Ring 6. For example, if a member failed to qualify for rewards earned by members of his/her own team, his/her BurnRewards off those sales "rolled up" to the next qualified member in his/her upline. Ex. 8 § 6.2.3.

***(ii)* Product Package Bonuses**

The Product Package Bonus was the most straightforward of the compensation structures used by BurnLounge. In a nutshell, qualified Retailers/Moguls received BurnRewards equivalent to $10, $20, and $50 for the sale of the Basic, Exclusive, and VIP packages respectively.[26] Ex. 8 § 6.3.1. The Retailer/Mogul must have sold at least 2 albums to non-Moguls in the previous month and have maintained a positive Burn-Rewards account balance. Ex. 8 § 6.3.1. Retailers and Moguls who were not qualified for the Product Package Bonuses received only the $5.99 Concentric Retail Commission. Id.

***(iii)* Mogul Team Bonuses**

The most lucrative (and most complicated) compensation vehicle is the Mogul Team Bonus. The Mogul Team Bonus uses a "binary" structure common to MLM companies to organize team members in such a way that it prevents one from free-riding off the efforts of another team member. Kevin Keranen Tr. Day 7 at 247:8-250:19.

In order to receive the Mogul Team Bonus, a Mogul must have become a "Qualified" Mogul. Ex. 8 §§ 6.1.4, 6.3.2. The requirements included: 1) "one-time" requirements of selling (a) two Exclusive or VIP packages and (b) at least two album sales to non-Moguls;[27] and 2) "monthly" requirement of selling at least two albums in the previous calendar month to non-moguls. Ex. 8 § 6.1.4. To work towards the Mogul Team Bonus, each Mogul established two Mogul Teams, his/her A-Team and his/her B-Team, into which new recruits would be placed.

As a Mogul and the members of his/her two teams sold the premium product packages (i.e. the Exclusive and VIP packages), they acquired Mogul Team Points (which were distinct from BurnReward Points) for the members of their respective teams. Sale of a VIP package yielded 400 points and an Exclusive package, 100 points.[28] Ex. 8 § 6.3.2. Mogul Team Points were awarded to the team once the newly recruited Retailer sold 2 albums. Ex. 31 at 36-37. These points accrued as long as the Mogul maintained

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[26] The totals for the Product Package Bonus are actually a combination of the Concentric Retail commission and the Product Package Bonus. For example, the VIP Package Bonus consists of a $5.99 Concentric Retail commission and a $44.01 VIP Bonus. Ex. 8 § 6.3.1.

[27] Exclusive and VIP Moguls who joined BurnLouonge prior to its official launch on June 10, 2006, were exempted from the one-time requirements. Ex. 8 § 6.1.4.

[28] For a period of time, sales of the Basic Package yielded 30 Mogul Team Points. Murray Tr. Day 6 PM at 8:21-82:4.

his/her qualifications. Id.

(A) Building a Mogul Team

A Mogul Team was built of multiple layers of subsequently recruited Moguls. The layers of the team expanded exponentially, with each Mogul having two team members directly below him/her, each of those members having two below him/her, and so on. See Ex. 423 at 2, 4. Each new recruit (i.e. individual to whom a premium Product Package was sold) was placed in one or the other of his/her sponsoring Mogul's teams. Ex. 8 § 6.3.2. Because each level of each team only had one member, when a second recruit was placed on, say, a Mogul's A-Team, that new recruit would fill the A slot of the next level down.[29] See Vander Nat Tr. Day 4 PM at 103:4-6.

Thus, if John, a "Qualified" Mogul, recruited two individuals, Al and Bob, they would be placed on the first level below John: Al on the A-Team, and Bob on the B-Team. If John then recruited Bill, Bill would be the second member of John's A-Team and be placed below Al (by default onto Al's A-Team). This placement puts Bill into not only John's A-Team downline, but also into Al's A-Team downline. See Ex. 423 at 2. This placement of Bill would yield Mogul Team Points not only for John, who recruited Bill, but also for Al. See Vander Nat Tr. Day 4 PM at 103:4-104:6. If John then recruited Joe, Joe would be placed on John's B-Team under Bob (i.e. on Bob's B team). This placement of Joe yields Mogul Team Points for John and Bob. See Ex. 423 at 2. It should be noted that the recruitment of Joe does not yield points for Bill or Al because Joe was placed on John's B-Team while Bill and Al are on John's A-Team.

(B) Balancing Mogul Team Points

It is important to note that any recruitment by a Mogul's upline will only ever add points to one of that Mogul's teams. For example, John's future recruits, if they ended up on John's A-Team, would always have been added only to Al's and Bill's respective A-Teams, never their B-Teams. More importantly, any points Bill gained by John's recruitment efforts would always be applied to his A-Team. But Mogul Team Points earned for only one team were useless. In order to convert those points into BurnRewards, (explained below) they must have been matched or "balanced" by points on his/her B-Team. But Al could not rely on the efforts of his upline (i.e. John and Al) or his A-Team downline (represented by "Sue" on Ex. 423 at 2) to recruit or develop his B-Team. He had to do it himself. Thus, the splitting of each level into two teams encouraged participation by each member of each level and prevented free-riding on the efforts of his/her team members; if Bill did not add new members to his B-Team, he could not balance (and thus could not profit off of) the points generated by John, Al, and/or Sue. See Kevin Keranen Tr. Day 7 at 247:8-250:19.

Each time a Mogul acquired 300 Mogul Team Points on each of his/her teams (300 points on the A-Team and 300 points on the B-Team for a total of 600 points), he/she would receive a Mogul Team Bonus yielding a number of BurnReward Points. Ex. 8 § 6.3.2. How many BurnReward points were awarded varied depending on the

[29] The Levels of a Mogul Team, which are more or less a product of the chronology of recruitment, are not to be confused with the Rings of Concentric Retail, which are a product of who recruited whom into the program. Mogul Team Layers and Concentric Retail Rings are separate and unrelated. Ex. 423 at p.3.

package the Mogul had purchased and/or the level of album sales he/she had achieved. Id. A VIP Mogul would earn a Mogul Team Bonus of $50 worth of points. An Exclusive Mogul would earn $25 worth until he/she sold $500 worth of music, after which he/she would earn $50. Id. A Basic Mogul would earn no points until he/she sold $500 in music downloads (for the $25 Mogul Team Bonus) or $1000 in music downloads (for the $50 Mogul Team Bonus). Id.

(j) Statistics as to BurnLounge's Operations

BurnLounge ultimately recruited approximately 62,250 people into the BurnLounge program. Exs. 330 (at page 1)[30] & 422. 1,980 were only Retailers while 60,270 became Moguls. Id.[31] Of the 1,980 non-Mogul Retailers, 1,297 (65.5%) purchased the Basic Package, 341 (17.2%) purchased the Exclusive Package, and 342 (17.3%) purchased the VIP package. Ex. 422. Of the 60,270 Moguls, 2,518 (4.2%) purchased the Basic Package, 17,359 (28.8%) purchased the Exclusive Package, and 40,393 (67%) purchased the VIP Package. Ex. 422.

In the roughly two plus years of its operation, BurnLounge took in approximately $28,386,280 million in revenue from the endeavors of Retailers and Moguls. Ex. 330 at page 1. Music sales to Moguls accounted for $489,083, while their sales of product packages brought in $19,686,327. Id. 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. Id. Music sales to non-Mogul Retailers totaled $13,581, while their sales of product packages totaled $221,175. Id. Music downloads to persons other than BurnLounge Retailers and Moguls generated $1,000,576.

BurnLounge paid out $17,458,276 in commissions. Ex. 330. 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. Ex. 421; Vander Nat Tr. Day 5 AM at 14:13-15:12.

After the FTC filed this action, sales plummeted. See Exs. 65, 67, 68 (showing revenues dropped from $476,516 in June 2007 to $15,270 in July, and to $10,880 in August).

About 93.84% of all the Moguls (i.e. 56,557) never recouped their investment in the BurnLounge scheme. Ex. 421; Vander Nat Tr. Day 4 PM at 44:15-46:4; Vander Nat Tr. Day 5 AM at 9:11-13:1. That "business failure rate" was 92.8% for VIP Moguls, 96.3% for Exclusive Moguls, and 93.6% for Basin Moguls. Ex. 421.

The FTC's expert witness testified that, if the BurnLounge recruitment program were to operate at its "optimal" level (i.e. with each new participant purchasing the VIP package which allowed for the quickest and highest return, and with each participant in

[30] Exhibit 330 at page 1 indicates that there were 56,017 persons who were "never a Mogul" and who "didn't buy music package" which would mean that they were also not BurnLounge Retailers. Those persons are credited with having spent $1,000,576 for "music downloads (a la carte)," $4,856 for "merchandise purchases (a la carte)," and $112 for "payments $8.00 (BLP [BurnLounge Presents] monthly fees)." Presumably, those 56,017 persons were customers of BurnLounge Retailers and Moguls.

[31] There is a discrepancy between the data in Exhibit 330 and Exhibit 422. Exhibit 422 reports a total of 60,270 Moguls and Exhibit 330 at page 1 shows 60,269. However, as Exhibit 330 indicates, one "Mogul" entry is actually BurnLounge's A&R department and not a real person recruited as a Retailer/Mogul.

turn following the rules of the program in order to maximize his/her rewards), "even under those best of circumstances some 87.5 percent of the participants would not recoup their [investment]." Vander Nat Tr. Day 4 PM at 45:7-23. This result is due to the simple mathematics involved in BurnLounge's Mogul compensation program where continued recruitment of new members is needed to create and fund the significant returns for certain of the existing participants. See Exs. 43, 418, 419; Vander Nat Tr. Day 4 at 53:14-59: 25 and 63:4-65:4. 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. Vander Nat Tr. Day 4 at 70:15-72:19.

(k) The Marketing of BurnLounge Product Packages

BurnLounge sold its product packages in tandem with marketing its business opportunity, which focused on recruiting new participants. Defendant Arnold testified that BurnLounge's model was to turn music fans into entrepreneurs. See Arnold Tr. Day 4 AM at 23:19-25:1. 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. Ex. 422. Granted, an individual could purchase a Product Package for the bundled products and the business opportunity. But 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. For instance, 67% of Moguls purchased the VIP Package, while only 17.3% of non-Mogul Retailers purchased the same. Ex. 422. 28.8% of Moguls purchased the Exclusive Package, compared with only 17.2% of non-Mogul Retailers. Id. 4.2% of Moguls purchased the Basic Package, compared with 65.5% of non-Mogul Retailers. Id.

(l) Income Claims Made by the Defendants

Although BurnLounge had a policy against making income claims, Ex. 8 § 3.6.2, income claims were made by Defendants Arnold, Taylor, and DeBoer (such as the following) at meetings throughout the country and during live and prerecorded[32] telephone conference calls promoting BurnLounge or training its participants:

***(i)* Alex Arnold**

> [W]e're paying people 10, 25, $50,000 a month to go out there and tell their story.

Ex. 33 at 22:3-5.

> You will never get rich off your store, ever. You'll pay for gas and a couple of cab fairs [sic] per week. But if you build a community that sells a few movies and sells a few games and sells a few downloads, you will have a license to print money .... J.T. made $50,000 two weeks ago. He's going to make probably $700,000 this year, and he's a good old boy

[32] Prerecorded calls were accessed through dial-on-demand telephone numbers or the Internet. See e.g. Ex. 20 at 3: 6-11, 4:17-21, 10:8-10; Ex. 24 at 3:8-13, 6:7-9, 22: 19-21; Ex. 26 at 3:7-11, 20: 20-23; Ex. 30 at 3:7-12, 5:13-6:10; Ex. 31 at 3:7-11, 4:9-14; Ex. 32 at 3:7-13, 25:1-27:22; Ex. 41 at 3:7-11, 4:17-25; Ex. 45 at 3:7-12, 12:14-20; Ex. 48 at 3:7-12.

> from Texas that can't read.

Ex. 33 at 29:23-30:6; Arnold Day 4 AM at 93:23-94:10.

> In this industry, direct sales, I created a seven-figure income by the time I was 25 years-old, and now, I plan on doing that for hundreds, thousands of people worldwide selling entertainment and digital content over the course of the next three years.

Ex. 1 at 155:13-18.

> If somebody wants to come in and generate a few hundred dollars a month, they can do that as well. If somebody wants to turn it into an incredible business and create distribution and retail, they have the ability to do that as well.

Ex. 316 at 8:9-12.

***(ii)* John Taylor**

> [O]ver the last six months, I've had a chance to generate well over $340,000 in income. In the last 30 days, it was over $70,000. . . . So, Scott [Elliott], you know, seven people in the company have -- you know, I've had a chance to work with that have generated well over $200,000 in the last six months. We've got residual checks in the company right now today that are a six-figure income, well over six figures.

Ex. 19 at 30:8-31:1.

> I want to make sure you guys can have whatever amount of money that you want. Some of you in this room are worth millions. There's some of you in this room that want to make money. There's some of you in here that are looking for 1,000 a month, looking for 1,000 a week, and there's some of you looking for 1,000 a day. Just depends on what you want out of this business.

Ex. 37 at 45:22-46:4.

> [H]e's a person, you know, that needs no introduction because he's out there just working tirelessly and creating – you know, incomes of you know, between $15,000 to $20,000 a week in income within this business model. I know he just received a check like that within his business just the other day and he's had weeks upon weeks upon weeks like that.

Ex. 20 at 4:17-21.

> We have 1,000 checks a week that go out to the field. Some of those checks are pretty, pretty incredible. At the same time, some of those checks are you know, $1,000 a month, $1,000 a week, $1,000 a day.

Ex. 33 at 15:8-11.

***(iii)* Rob DeBoer**

> Guys, we've made just under $300,000. Todd Ellis' next door neighbor has made $280,000. We've got a dozen people that have made over $100,000. A lot of people – I don't say that to impress you. We're in Columbia, you're in Atlanta, you have people of influence here.

Ex. 18 at 23:23-24:3.

> We're not here to make financial claims, but I can tell you, I walked away

> from my job two months into this. My 10 best friends have made between one and $350,000 in the last six months. They've never done anything like this.

Ex. 33 at 6:8-12.

> [M]y 10 best friends who have never done anything like this, didn't know anything about the industry, they've all made between 1 and $300,000 in the last seven months. In Columbia. You guys live in Chicago.

Ex. 35 at 45:25-46:3.

> And for a low entry level of $450 to participate and get the support and help with proven retailers that have already maximized the business model, that have already earned tens of thousands and hundreds of thousands of dollars with, frankly, an inferior product.

Ex. 41 at 7:4-9.

> Guys, I shared it with a few of my best friends. It's turned into a seven-figure annualized income. Nobody's that good, nobody's that smart in sales. This concept has to make sense.

Ex. 48 at 14:5-8.

Some of those statements were unambiguously false. Nobody made a seven-figure income from BurnLounge; there was no evidence that anyone ever earned nearly $20,000 a week in income (at least, not for any significant amount of time); and it is obvious that John Taylor came nowhere near to earning $700,000 in 2006 and he is not actually illiterate.

Income claims were pervasive among persons marketing the BurnLounge program. At times, certain BurnLounge officers did try to curb that practice. For example, Bernie Rivera, head of BurnLounge Customer Service Department, which had the responsibility of enforcing BurnLounge's policies and procedures, testified that his unit "a couple of times a week" dealt with income claims made by Retailers. Rivera Tr. Day 2 PM at 16:1-18:3, 28:18-25. Aware of the problem with income claims, Executive Vice President Kevin Keranan gave a speech before two thousand attendees at a Burn-Lounge meeting and stating: "Income claims. Guys we cannot afford it. We gotta stop doing it." Ex. 219 at D0010559; Keranan Tr. Day 7 at 311:13-21. Keranan also spoke with Defendant Arnold about income claims being made by Retailers. Arnold Tr. Day 4 AM at 62:22-63:12. Ryan Dadd, President of BurnLounge, wrote to Arnold confronting him about Arnold's making an income claim at one BurnLounge event. Ex. 252; Arnold Tr. Day 4 AM at 95:24-97:21. Keranan testified that to the best of his knowledge no one was ever terminated for making income claims. Keranan Tr. Day 7 at 304:9-13.

(m) Material Omissions

None of the BurnLounge promotional material or the recorded sales presentations adequately disclosed that BurnLounge Moguls were not likely to make substantial income. See generally Exs. 1-10, 12-13, 18-33, 35, 37, 39, 41-43, 46, 48-49, 317, 379, 380, 293, and 316. Defendants Arnold, Taylor and DeBoer, when they made claims about their own income or that of other BurnLounge participants, never said the incomes were not typical, never said they were not representative of what the majority of Moguls would earn, and never disclosed that the majority of Moguls would not earn a profit. Ex.

281 at 64:17-65:7.

BurnLounge Policies, to which Retailers were required to agree, prohibited the making of income claims. Ex. 8 § 3.6.2. While the Policies allowed the use of income examples, they were only to be utilized if it was made clear that the earnings were hypothetical and that the prospective participant was provided a current copy of the "BurnLounge's official income disclosure statement." Ex. 8 § 3.6.2. However, income claims were constantly being made by BurnLounge representatives without any sanctions from the company. Moreover, BurnLounge did not prepare an income disclosure statement until shortly before the filing of this matter, approximately 18 months after it began recruiting Moguls. Keranan Tr. Day 7 at 313:7-14; Ex. 220 at 48. BurnLounge argues that prior to that preparation, it would be difficult to make an accurate representation on the earnings of Moguls because of BurnLounge's lack of a prior operating history.[33]

II. DISCUSSION

(a) Applicable Law

The primary issue before the Court is whether BurnLounge operated an illegal pyramid scheme. Operating a pyramid scheme is an unfair or deceptive act affecting commerce for purposes of Section 5(a) of the FTC Act. 15 U.S.C. § 45(a); see e.g., FTC v. Five-Star Auto Club, Inc., 97 F. Supp. 2d 502, 527-33 (S.D.N.Y. 2000). Typically, pyramid schemes depend on perpetual recruitment of new participants in an exponential fashion, such that the scheme "may make money for those at the top of the chain or pyramid, but 'must end up disappointing those at the bottom who can find no recruits.'" Webster v. Omnitrition Int'l, 79 F.3d 776, 781 (9th Cir. 1996) (quoting In re Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1181 (1975)) ("Koscot"). Pyramid schemes are inherently fraudulent "because they must eventually collapse." Id. at 781.

The Ninth Circuit has adopted the FTC's test from Koscot to determine the existence of a pyramid scheme. Omnitrition Int'l, 79 F.3d at 781. Under that test, 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.

Koscot, 86 F.T.C. at 1181.[34] As further observed in Omnitrition Int'l, 79 F.3d at 781:

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[33] However, if the BurnLounge venture is a pyramid scheme, one would know from its outset that the earnings of the vast majority of its participants would never cover their initial investments as a matter of simple mathematics.

[34] As described in Five-Star Auto Club, Inc., 97 F. Supp. 2d at 531:

> A pyramid scheme is a mechanism used to transfer funds from one person to another. In the most extreme form of a pyramid scheme, there is no product or service; instead, people are motivated to join by promises of a certain portion of the payments made by those who join later and are placed in one's "downline." If enough additional people join the scheme, a given member could recoup his or her initial payment and even receive additional returns. But, by the nature of the scheme, those at the bottom of the structure at any given time will have lost money, and the number of consumers at the bottom who have lost money will

> The satisfaction of the second element of the Koscot test is the *sine qua non* of a pyramid scheme: "As is apparent, the presence of this second element, recruitment with rewards unrelated to product sales, is nothing more than an elaborate chain letter in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be diappointed."

Under Section 13(b) of the FTC act, "after proper proof, the court may issue a permanent injunction." 15 U.S.C. § 53(b). "The purpose of an injunction is to prevent future violations, Swift & Co. v. United States, 276 U.S. 311, 326 (1928), and, of course, it can be utilized even without a showing of past wrongs." United States v. W. T. Grant Co., 345 U.S. 629 (1953). "The necessary determination is that there exists some cognizable danger of recurrent violation . . . ." Id. In addition, the court has broad, flexible authority to grant equitable relief in the form of rescission, restitution or disgorgement. Porter v. Warner Holding Co., 328 U.S. 395, 397-98 (1946); Hecht Co. v. Bowles, 321 U.S. 321, 329 (1944); FTC v. Pantron I Corp., 33 F.3d 1088, 1102 (9th Cir. 1994); FTC v. H. N. Singer, Inc., 668 F.2d 1107, 1113 (9th Cir. 1982).

(b) The Existence of a Pyramid

"Whether a multi-level marketing plan operates as an illegal pyramid scheme is determined by how it functions in practice." Whole Living, Inc. v. Tolman, 344 F. Supp. 2d 739, 745 (D. Utah 2004). As observed in FTC v. SkyBiz.com, Inc., 2001 U.S. Dist. LEXIS 26175 at *28 (N.D. Okla. Aug. 31, 2001):

> A lawful multi-level marketing program is distinguishable from an illegal pyramid scheme in the sense that the "primary purpose" of the 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."

At its core, BurnLouge's business consisted of two components: 1) the sale of "downloadable music and music-related products and services through . . . online BurnLouge software . . . by purchasing one of the three BurnLounge [product] packages" and 2) the "BurnLounge Mogul program, which allows [BurnLounge Retailer/Moguls] to turn their [Burn] rewards into cash." See Ex. 8 § 1.2. While both were promoted as business opportunities, it is/was readily apparent that only through the latter could one possibly achieve any significant financial return (as touted by BurnLounge's boosters) and even then only through the recruitment of new BurnLounge Retailer/Moguls via sales of Exclusive and VIP product packages, with those Retailer/Moguls in turn recruiting new participants, and so on.[35] Both as designed and in execution, the BurnLounge

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> grow exponentially as more people are recruited to join. Moreover, the required number of new members cannot, in fact, be recruited on a perpetual basis, causing the scheme to collapse of its own weight if it does not first falter when a significant number of members are unable to find enough people as gullible as themselves to recruit.

[35] These points were emphasized in BurnLounge's promotional materials and by the representations of its champions. See e.g. "New VIP Retailer Playbook" Ex. 43 at pages 3-5; Becker Tr. Day 1 PM at 78:6-

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. See Section I(j) supra. The Court finds that the FTC has established that a majority of the BurnLounge business (consisting of the Mogul program and related elements) was a pyramid scheme.

BurnLounge Retailers/Moguls paid at least $29.95 for the right to sell downloads in return for BurnRewards. The $29.95 charge gave the Retailer/Mogul access to the software needed to customize a BurnPage and manage its contents. While the Court may disagree with the amount charged for such software, it is clear that the software was physically necessary for a Mogul to operate his/her business, and it is not out of line for BurnLounge to have charged a nominal fee (less than $3.00 per month) for the use of that software.[36]

However, 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. See Matter of Amway Corp. Inc., 93 F.T.C. 618, 716 (1979) (distinguishing requisite purchase of a sales kit from a pyramid scheme's entry fee because "no profit was made [by the recruiter] in the sale of the Kit, and the purchase price may be refunded if the distributor decides to leave the business"); cf. Omnitrition Int'l, 79 F.3d at 782 ("Distributor" level of Omnitrition was not a pyramid scheme because "the participant pa[id] no money to Omnitrition . . . and ha[d] no right to receive compensation for recruiting others into the program. The distributor level, however, is only a small part of the entire program.").

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. 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

79:16; Ex. 40 at 1147 (which highlighted the hundreds of dollars to be made from the "balanced" sales of VIP packages, but noted only that there would be a concomitant "small profit from any music sales").

[36] The $6.95 monthly Mogul Fee is not an important element here because the sponsoring Retailer/Mogul did not receive commission off of it. Suffice it to say that the overwhelming majority of participants paid the fee in order to be able to convert their BurnRewards and/or Mogul Team Bonuses into cash.

[37] The FTC points to language in the BurnLounge's Policies for the contention that Retailers and Moguls were not ultimate users because "end customer" was defined in that document as being a non-Retailer. See Ex. 8 § 12. Semantic differences aside, the FTC's argument is supportive but not controlling. Burn-Lounge's definition of an end customer would not be determinative as to whom the Court may consider to be the ultimate user of a product.

meager rewards of vending the music downloads available on the BurnLounge system. Ex. 330; Vander Nat Tr. Day 4 PM at 72:6-12 ("when you compare Mogul rewards to actual album sales, the ratio is roughly $17 in Mogul rewards for every one dollar of album sales."); see U.S. v. Gold Unlimited, Inc., 177 F.3d 472, 481 (6th Cir. 1999) (noting that, in determining whether a pyramid exists, evidence of a marketing program's effect deserves more weight than that of its policies). As noted in Omnitrition Int'l, 79 F.3d at 782: "The promise of lucrative rewards for recruiting others tends to induce participants to focus on the recruitment side of the business at the expense of their retail marketing efforts, making it unlikely that meaningful opportunities for retail sales will occur." Thus, the fact that some retail sales occur does not mitigate the unlawful nature of the overall arrangement. Omnitrition Int'l, 79 F.3d at 782, citing In re Ger-Ro-Mar, Inc., 84 F.T.C. 95, 148-49 (1974), rev'd on other grounds, 518 F.2d 33 (2d Cir. 1975). The danger of such "recruitment focus" is present in the BurnLounge program. Id. 79 F.3d at 782. The Court thus finds that, at least initially, BurnLounge's compensation for the first $29.95 of each Product Package was directly tied to recruitment, fails the Koscot test, and was part of the pyramid scheme.

Starting in April of 2007, when BurnLounge began to offer a limited version of the BurnPage at no charge, the business opportunity was untied from the Basic Package. In other words, because one no longer needed to purchase the Basic Package to participate in the business, sales and fees as to the Basic Package after April 2007 were not linked to recruiting.[38]

BurnLounge's premium packages (i.e. the Exclusive and the VIP Packages) included all of the benefits of the Basic Package (and thus the ability to participate in BurnLounge's business opportunity). In this sense, the Exclusive and VIP Packages, beyond the first $29.95 charged, were not prerequisites for participation as a Mogul. It may seem, then, that the additional $100 and $400 charges for those packages does not fall within the first prong of Koscot because they are not "characterized by the payment . . . of money . . . for . . . the right sell a product." Koscot, 86 F.T.C. at 1181.

Indeed, BurnLounge went to great lengths at the trial to argue that sales of the premium packages were sales of products (e.g. BurnLounge Presents, BurnLounge Magazine, the LiveNation EventPass, BurnLounge University, etc.) to ultimate users and that any rewards paid in return for recruiting were exclusively tied to those sales. But clearly that was not the case. The premium packages did contain bundles of products, and the Court finds that those products did have some extremely limited value to some consumers, but those packages also contained for their purchasers the opportunity to more quickly collect higher commissions (i.e. Mogul Team Bonuses) for the sale of those same items. Specifically, the Exclusive and VIP Packages allowed participants to bypass the album-sales requirements to obtain higher Mogul Team Bonuses ($25 and $50, respectively). In other words, a Basic Mogul could earn a $50 Mogul Team Bonus only after selling $1000 worth of music, but an Exclusive Mogul could earn the same after

[38] This presumes that Retailers using the free BurnPage could participate in the Mogul program, which appears to be supported by the evidence. Exhibit 330 shows a number of individuals who joined after April 2007, paid the Mogul fee, but paid no money for a Product Package. Ex. 330.

selling only $500 worth.[39] A VIP Mogul could earn the $50 bonus from the start.[40] This adjustment in the Mogul Team Bonus (based only upon the nature of the package purchased) was not a retail product, it was part of the business opportunity - the opportunity to earn higher commissions on specific transactions than he/she otherwise would. More importantly, it created a reason for prospective Moguls to purchase a premium package regardless of the value received from the products bundled within it.

In Omnitrition Int'l, the Ninth Circuit noted that, although participants could participate in the defendant's business opportunity at no charge, the wholesale purchase requirements for distributors to begin to earn commission on sales by their recruits made the program appear to be a pyramid scheme on its face. 79 F.3d at 782. Defendants argue that Omnitrition Int'l is distinguishable because it involved an inventory-loading scheme while BurnLounge did not require purchases of inventory. This is a distinction without a difference. Inventory-loading pyramids are not illegal simply because there are wholesale purchasing requirements. They are illegal because the purchases are incentivized by commissions that result from recruiting others to join the scheme through similar purchases. The FTC in Amway pointed out that participants in the Koscot and Holiday Magic pyramid schemes essentially paid to receive payment for recruiting. 93 F.T.C. at 715-16 (distinguishing the Amway program from a pyramid scheme because it "is not a plan where participants purchase the right to earn profits by recruiting other participants, who themselves are interested in recruitments fees rather than the sales of products."), citing Koscot, 86 F.T.C. at 1131, 1140, 1179; In the Matter of Holiday Magic, Inc., 84 F.T.C. 748, 1032, 1035 (1974). That primary recruitment emphasis is precisely how BurnLounge operated. 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. Such sales were not driven by market forces, but by the illusion that such an enterprise is sustainable at least long enough for the next purchaser to recoup his/her initial investment.

The Court finds BurnLounge's sales of the Exclusive and VIP Packages were directly tied to recruitment, fail the Koscot test, and were "pyramidal" in nature.

(c) Misleading Income Claims

A statement is misleading if the representation is likely to deceive reasonable consumers to their detriment. See Southwest Sunsites, Inc. v. F.T.C., 785 F.2d 1431, 1435 (9th Cir. 1986). Such misrepresentations are actionable under Section 5 even if made without an intent to deceive. FTC v. World Travel Vacation Brokers, Inc., 861 F.2d 1020, 1029 (7th Cir. 1988); Beneficial Corp. v. FTC, 542 F.2d 611, 617 (3d Cir.1976).

This Court finds that (from the evidence presented at the trial) all of the Defendants (including BurnLounge itself through the statements of its CEO Arnold and by its authorized agents at the various company sponsored presentations) made misleading affirmative representations regarding the actual and potential income of BurnLounge

[39] It does not appear from the evidence proffered at trial that any Basic or Exclusive Mogul ever achieved the delineated music sales volume necessary to qualify for a higher Mogul Team Bonus.

[40] This assumes the Mogul, whatever his/her level, was a "qualified" Mogul by satisfying the one-time requirement to sell two premium packages and the monthly requirement to sell two albums.

participants, and also failed to disclose material information (such as the fact that most participants would not be able to recover their initial outlays for the Exclusive and VIP Packages).

The Defendants argue that any misleading statements as to income were mere puffery and/or not material. That is not so. Generalized or exaggerated statements upon which reasonable consumers would not rely are considered "puffery" and are non-actionable. In re All Terrain Vehicle Litigation, 771 F.Supp. 1057, 1061 (C.D. Cal., 1991). In Cook, Perkiss and Liehe, Inc. v. Northern California Collection Service, 911 F.2d 242, 246 (9th Cir. 1990), the Ninth Circuit noted:

> In the FTC context, we have recognized puffery in advertising to be "claims [which] are either vague or highly subjective." Sterling Drug, Inc. v. Federal Trade Commission, 741 F.2d 1146, 1150 (9th Cir. 1984), cert. denied, 470 U.S. 1084 (1985). The common theme that seems to run through cases considering puffery in a variety of contexts is that consumer reliance will be induced by specific rather than general assertions.

Here, the misleading items were not vague or merely suggestive pronouncements, but rather specific references to actual (or purportedly actual) income amounts earned by individuals or groups of BurnLounge participants. For example, John Taylor never made $700,000 in any given year (as claimed by Arnold); there were never 1,000 checks a week going "out into the field" where some of them were for "$1,000 a day" (as touted by Taylor); and DeBoer was not making a seven-figure annualized income as he himself represented.

In addition, where 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. In Omnitrition Int'l, it was observed that:

> Misrepresentations, knowledge and intent follow from the inherently fraudulent nature of a pyramid scheme as a matter of law. As to justifiable reliance, ... the very reasons for the *per se* illegality of Endless Chain schemes is their inherent deceptiveness and the fact that the "futility" of the plan is not "apparent to the consumer participant."

79 F.3d at 788 (citations omitted). Here, the Defendants failed to disclose that material information.

(d) Harm to Consumers

BurnLounge criticizes the FTC for its description of the enterprise which equates selling with recruiting; but the structure of BurnLounge's Mogul compensation program tied recruiting and selling so closely together that the FTC's characterization is the only one possible. For the most part, nobody could be successfully recruited into the Mogul program unless they were sold a product package, and virtually everyone who was sold a product package was recruited into the Mogul program (i.e., 60,270 of the 62,250 individuals who purchased a BurnLounge product package joined the Mogul program at some point, which equals 96.8%). Ex. 422.

Because BurnLounge tied legitimate sales of products so closely with the illegitimate pyramidal business opportunity, the motivation of consumers in purchasing the product packages is vital to the calculation of consumer harm. Neither party, however, presented any type of survey evidence of the motivation of consumers in making their purchases; the FTC arguing that consumers only sought the business opportunity, and BurnLounge arguing that consumers primarily sought the value in the product packages despite the business opportunity. Neither argument is persuasive and the Court is entitled to make its own estimates based on the best available information. See FTC v. QT, Inc., 512 F.3d 858, 864 (7th Cir. 2008). The Court will determine the harm done to consumers as follows.

Of the 60,270 Mogul participants, 3,713 made a profit (i.e., had more than a return of their initial investment). Exs. 330, 422. These Moguls were not injured by the scheme and will be factored out for purposes of calculating harm to consumers.[41] The remaining number of Moguls is 56,557.

The Basic Package was of nominal value, absent the opportunity to earn money as a Mogul. Only about 3.2% (i.e., 1,980 ÷ 62,250) of all BurnLounge participants purchased a product package without participating in the Mogul program (i.e. arguably, for value offered other than the business opportunity). Ex. 422. However, of those who purchased a package, with or without participating in the business, a certain number must have found value outside of the Mogul program. That is, it can be inferred that at least some of the Moguls would have purchased the Basic Package even if the Mogul Program had not existed. 31.7% of non-Mogul users (both customers and Retailers) who registered an account at Burn-Lounge purchased at least one album.[42] Ex. 422. 3.4% of all users who registered purchased at least a Basic Package. Ex. 422. Assuming these groups overlapped completely,[43] 10.8% of non-Moguls (i.e. 31.7% × 3.4%) who purchased at least an album also purchased a package. The Court will use this as a rough estimate of the percentage of Moguls who would have found enough value in the Basic Package to purchase it absent the Mogul program.

Additionally, from approximately mid-April through June of 2008, the business opportunity was offered free and separate from the Basic Package. See § I(d) *supra*. During that time, Concentric Retail commissions on Basic Packages and on the first $29.95 of premium packages were not payment for recruiting and will not be calculated as part of the harm to consumers. In April of 2007, BurnLounge sold 1,685 product packages to Moguls. Ex. 330. The Court will estimate that half of these (843) were sold after the free BurnPages became available. In May of 2007, BurnLounge sold 2,059 product packages, and in June, 421. Ex. 330. This is a total of 3,323 sales to Moguls which will be excluded from the calculation (56,557 – 3,323 = 53,234).

Using all of the above as a rough measure of the harm done to consumers, the Court finds that 89.2% of all revenues collected from Moguls for the Basic Package (and

[41] This is especially true since the FTC is not seeking any restitution/disgorgement from the Moguls who made a profit from the BurnLounge scheme, with the exceptions of Taylor and DeBoer.

[42] The remainder either created an account without making any purchase or perhaps purchased only a handful of individual songs.

[43] Even if it is assumed they do not overlap at all, the numbers in the final calculation do not change very much.

including the first $29.95 of each premium package) constitute consumer harm from BurnLounge's operation of its pyramid scheme. That total is $1,422,167.60 ($29.95 x 53,234 Moguls x 89.2%).

The products bundled into the premium product packages did have some tangible value, and it can be inferred that at least some Moguls purchased those packages for the value offered. Retailers paid $100 above the cost of a Basic Package for the Exclusive Package. Retailers paid $300 above the cost of an Exclusive Package for the VIP Package.

Giving the Defendants a generous benefit of the doubt on this point, the Court will use the percentage of non-Mogul Retailers who purchased either an Exclusive or VIP package (34.5%) as a proxy for determining the percentage of Moguls who purchased the Exclusive package specifically for the value of the products received rather than solely for the increased Mogul Bonus opportunity.[44] Ex. 422. By this measure, the harm done to consumers by the sale of the Exclusive Package is 65.5% of the Exclusive portion ($100) of every premium package sold. That total is $3,539,554.50 ($100 x 54,039 premium package Moguls[45] x 65.5%).

Additionally, premium Moguls paid a BurnLounge Presents fee of $8.00 per month. BurnLounge took in $2,912,040.00 in monthly BurnLounge Presents fees from unprofitable Moguls. Ex. 330. Discounting those who likely purchased their premium package for its product value, the Court finds total harm done to consumers of $1,907,386.20 ($2,912,040.00 x 65.5%).

The Court will use the percentage of non-Mogul Retailers who purchased a VIP package (17.3%) as a proxy for determining the percentage of Moguls who purchased the same specifically for the value of the products received rather than for the increased Mogul Bonus opportunity. By this measure, the harm done to consumers by the sale of the VIP package is 82.7% of the VIP portion ($300) of every VIP Package sold. That total is $9,376,691.40 ($300 x 37,794 VIP Moguls[46] x 82.7%).

Total harm to consumers therefore equals $1,422,167.60 + $3,539,554.50 + $1,907,386.20 + $9,376,691.40 = $16,245,799.70.[47]

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[44] The non-Mogul purchases of the VIP Package are included because that package included every product in the Exclusive Package as if it were purchased separately.

[45] There were 57,572 premium BurnLounge packages sold – 40,393 VIP Packages and 17,359 Exclusive Packages. Ex. 422. This Court will treat the 3713 Moguls who made a profit as all falling within those two categories and in the same ratio (i.e. 70% in the VIP Mogul group and 30% in the Exclusive Mogul group). 57,752 premium package Moguls minus 3,713 profiting Moguls equals 54,039.

[46] Of the 3713 Moguls who made a profit, 70% would fall within the VIP category (see footnote 45, supra), which would equal 2599. Therefore, of the 40,393 individuals who purchased a VIP Package, 37,794 did not make any profit and would be considered in the harm calculation.

[47] Payment of the Mogul fee was used in determining which Moguls experienced a net loss on their business. However, the calculation of harm to Moguls (who failed to make a profit) does not factor in the Mogul fee, which served both legitimate and illegitimate purposes, or any offset for commissions paid to those same Moguls, which compensated both legitimate and illegitimate parts of the business. By coincidence, these two totals differ by very little, Ex. 330, and even if the legitimate and illegitimate purposes could be separated from each, the result would likely be a wash. For the sake of simplicity they are simply ignored in the estimation of consumer harm.

(e) Liability of Individual Defendants

***(i)* BurnLounge and Arnold**

The FTC argues that Defendant Arnold should be held jointly and severally liable for any amount owed by BurnLounge. This Court generally agrees. As an officer, Arnold:

> . . . may be held individually liable for injunctive relief under the [Federal Trade Commission Act] for corporate practices if the FTC can prove (1) that the corporation committed misrepresentations or omissions of a kind usually relied on by a reasonably prudent person, resulting in consumer injury, and (2) that [defendant] participated directly in the acts or practices or had authority to control them. * * * * [and (3) he/she] had knowledge that the corporation or one of its agents engaged in dishonest or fraudulent conduct, that the misrepresentations were the type upon which a reasonable and prudent person would rely, and that consumer injury resulted.

FTC v. Publishing Clearing House, Inc., 104 F.3d 1168, 1170-71 (9th Cir. 1997), quoting FTC v. American Standard Credit Systems, Inc., 874 F.Supp. 1080, 1087-89 (C.D. Cal. 1994).

Defendant Arnold is liable because he indeed had the ability to control BurnLounge. He was the originator of the BurnLounge concept, was one of its primary investors and shareholders, was recognized as the "boss" and its "ultimate authority," and spearheaded the making of the compensation plan. It is undisputed that he was the controlling force behind the creation of what in essence was a pyramid scheme. Further, because a majority of the BurnLounge enterprise was an illegal pyramid operation, "misrepresentation[], knowledge and intent follow from the inherently fraudulent nature" of that scheme "as a matter of law." Omnitrition Int'l, 79 F.3d at 788.

Thus, both BurnLounge and Arnold are liable for the total amount of the harm to consumers determined above to be in the amount of $16,245,799.70.[48]

***(ii)* Taylor**

The Court finds that Taylor is not an innocent investor in the BurnLounge enterprise. While not formally an officer or employee of the company, Taylor was involved at the beginning in the raising capital funds for BurnLounge. He also owned stock and was provided with stock options. He had previously participated with Arnold in various network marketing companies. Very importantly, he was placed in first position at the binary structure of BurnLounge's Mogul compensation plan as "Retailer 001." Furthermore, he made material misrepresentations at BurnLounge's public functions where he was (on occasion) introduced as "Mr. Arnold's right-hand man."

Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), provides not only for the issuance of injunctive relief, but also the authority to grant any ancillary relief necessary to accomplish complete justice, including orders for restitution and

[48] The finding as to Arnold's liability for the $16,245,799.70 is premised on the Court's understanding that the FTC intends to utilize any recovered amounts in this case to directly reimburse individuals who lost their investments in the BurnLounge scheme. Should that premise be incorrect, the Court would alternatively order Arnold to disgorge the monies and other items of enrichment which he received from BurnLounge and which total $1,664,566.45. See Pantron I Corp., 33 F.3d at 1103 n.34.

disgorgement. Pantron I Corp., 33 F.3d at 1102. In light of the extent of his involvement in the BurnLounge scheme, the Court finds that Taylor should be required to disgorge all monies and other items of enrichment which he obtained from BurnLounge's operations. That amount, as previously noted, is $620,139.64.

(iii) **DeBoer**

As to Defendant DeBoer, he was not involved in any way in the creation or structure of the BurnLounge business. It is true that DeBoer did work to promote the enterprise and secure recruits, but so did a myriad of other Retailer/Moguls. Indeed, had he not been so effective a salesman, he would be one of the victims of the scheme whom the FTC seeks to protect in this litigation. However, he did speak at certain of the company's presentations where he made some misleading statements as to income. While he could be held liable as to those persons whom his statements directly mislead, the FTC has not provided any evidence which identifies either the individuals who were in fact mislead by DeBoer or the amounts of their losses.

There is one Ninth Circuit case which is somewhat germane to DeBoer's situation. In Donell v. Kowell, 533 F.3d 762 (9th Cir. 2004), the defendant Kowell unwittingly joined a Ponzi scheme (where the business eventually went into receivership) and made a profit of several thousand dollars. Years later, despite being an innocent participant, he was sued by the receiver and ordered by the trial court to return a portion of the profits he acquired from the fraudulent scheme (recovery of the other portion was barred by the statute of limitations). In upholding the order, the Ninth Circuit wrote:

> [T]he general rule is that to the extent innocent investors have received payments in excess of the amounts of principal that they originally invested, those payments are avoidable as fraudulent transfers:
>
> > The money used for the [underlying investments] came from investors gulled by fraudulent representations. [The defendant] was one of those investors, and it may seem "only fair" that he should be entitled to the profits on trades made with his money. That would be true as between him and [the Ponzi scheme operator]. It is not true as between him and either the creditors of or the other investors in the corporations. He should not be permitted to benefit from a fraud at their expense merely because he was not himself to blame for the fraud. All he is being asked to do is to return the net profits of his investment - the difference between what he put in at the beginning and what he had at the end.
>
> Scholes [v. Lehmann], 56 F.3d [750,] 757-58 [(7th Cir. 1995)]; see also In re Slatkin, 525 F.3d 805, 814-15 (9th Cir. [] 2008). The policy justification is ratable distribution of remaining assets among all the defrauded investors. The "winners" in the Ponzi scheme, even if innocent of any fraud themselves, should not be permitted to "enjoy an advantage over later investors sucked into the Ponzi scheme who were

> not so lucky." In re United Energy Corp., 944 F.2d 589, 596 (9th Cir. 1991).

Donell, 533 F.3d at 770.

However, there are material differences between the Donell case and DeBoer's situation. First, the receiver in Donell was acting pursuant to a court order to locate the business's assets and hence was proceeding against all of the investors in the Ponzi scheme who had made a profit. Here, the FTC is not pursuing any of the 3,713 participants in the BurnLounge scheme who made a profit other than Taylor and DeBoer (despite the fact that the FTC purportedly has a spreadsheet listing everyone who participated and what they profited/lost). Second, the action/order in Donell was initiated pursuant to a California state statute (i.e. the Uniform Fraudulent Transfer Act, Cal. Civ. Code § 3439.04) which is not applicable herein. Third, the receiver in Donell had authorization to "bring such legal actions based on law or equity . . . as he deems necessary," while the FTC here can only seek equitable relief. The judgment against Kowell in Donell appears to be one at law because there were no particular funds that had to be surrendered. Notably, in Donell, the victims (whom the receiver represented) were referred to repeatedly as "creditors," but in Great-West Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204, 213-14 (2002), the Court said essentially that there is no equitable relief for the claims of creditors - ("The basis for petitioners' claim is not that respondents hold particular funds that . . . belong to petitioners, but that petitioners are contractually entitled to some funds for benefits that they conferred. The kind of restitution that petitioners seek, therefore is not equitable . . . but legal . . . ."); but see FTC v. Direct Marketing Concepts, Inc., 648 F.Supp.2d 202, 213-14, 217-20 (D. Mass. 2009) (purporting to avoid granting a legal remedy, but ordering disgorgement in the amount of sales revenues as opposed to profits because it is "equivalent to the grant of a full purchase price refund to consumers.").

Here, the Court would order some level of disgorgement of profits from DeBoer. However, the problem is that the FTC has failed to establish with any precision what was the exact amount of the profit. While it is not disputed that DeBoer earned $908,293.69 from his BurnLounge endeavors, as a matter of equity the Court would allow him to deduct his expenses in obtaining those sums including: the amounts he expended in travel and similar costs, processing fees, taxes that he paid on that income, etc. Also, some of DeBoer's earnings would have been derived from the sale of music and other items which would not involve the improper sales of business opportunity giving rise to the sanctionable pyramid scheme.

In light of the above, the Court sets $150,000 as the disgorgement of profits amount with the expectation that the actual figure is certainly much higher, but the FTC has not established what the precise figure would be.

III. CONCLUSION

The Court finds by a preponderance of the evidence that: (1) Defendants BurnLounge and Arnold violated Section 5 of the FTC Act, 15 U.S.C. § 45(a), by creating and promoting a pyramid scheme; (2) that all of the Defendants engaged in deceptive acts or practices as described above in violation of Section 5 of the FTC Act; and (3) it is appropriate in the interests of justice for each Defendant to pay the amounts delineanted herein.

Further, permanent injunctive relief is warranted pursuant to 15 U.S.C. §§ 45 and 53. Plaintiff FTC is ordered to amend and resubmit its [Proposed] Final Judgment and Order for Permanent Injunction and other Equitable Relief (Doc. Item No. 413-2) so as to conform with this Statement of Decision (including consideration of footnote 48, supra).

Dated: This 1st day of July, 2011.

George H. Wu
GEORGE H. WU
United States District Judge