

FTC v. BurnLounge Points and Authorities

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
WESTERN DIVISION

FEDERAL TRADE COMMISSION,) Case No. CV 07-3654-GW (FMOx)
)
Plaintiff) **MEMORANDUM OF POINTS AND**
) **AUTHORITIES IN SUPPORT OF**
v.) **PLAINTIFF'S APPLICATION FOR**
) **TEMPORARY RESTRAINING ORDER**
BURNLOUNGE, INC., et al.,) **WITH CONDUCT PROHIBITIONS AND**
) **ASSET FREEZE, ORDER TO PRESERVE**
Defendants.) **RECORDS AND PROVIDE BUSINESS**
) **AND FINANCIAL INFORMATION, AND**
) **ORDER TO SHOW CAUSE WHY A**
) **PRELIMINARY INJUNCTION SHOULD**
) **NOT ISSUE**

I. INTRODUCTION

The Federal Trade Commission ("FTC") is seeking a temporary restraining order ("TRO") against Defendants BurnLounge, Inc. ("BumLounge"), Juan Alexander Arnold, John Taylor, Rob DeBoer, and Scott Elliott. Since 2005, Defendants have marketed a pyramid scheme though out the country. Defendants recruit others into the scheme by selling product packages to them that include an Internet-based, virtual music store ("on-line store"). By joining BumLounge, participants obtain the right to earn rewards for recruiting others into the scheme as well as for selling digital music through the on-line stores. Participants, who pay an additional monthly fee, can earn monetary rewards from BurnLounge and are known as "Moguls". The BurnLounge compensation program is based primarily on providing payments for the recruitment of new participants not retail sales of music, and the rewards for recruitment are essentially unrelated to retail sales of music. Such schemes are inherently deceptive and violate Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45(a). Through its very structure, the BurnLounge pyramid scheme will result in the majority of Moguls losing money and millions of dollars of consumer injury. Defendants also violate Section 5 of the FTC Act by misrepresenting the income to be earned through BumLounge and failing to disclose that most Moguls will lose money. Plaintiff seeks a noticed ex parte TRO to stop Defendants' illegal conduct, freeze their assets, require an accounting and expedited discovery and order that Defendants show cause why a preliminary injunction should not issue.

II. VENUE

Venue in this District is proper pursuant to Section 13(b)(2) of the Federal Trade Commission Act ("FTC Act"), 15 U.S.C. § 53(b)(2), and 28 U.S.C. § 1391. All Defendants do not reside in the same judicial district and a substantial portion of the events giving rise to the claim have occurred in the Central District of California. BumLounge promotes, recruits, sells, and operates its business in the Central District. (Gale 112-7, 9, Ex. 1-3, 8, pp. 1-2, 6-273, 318; Liggins 8, Ex. 20, pp. 394, 493-96, 509; Marino 5, Ex. 33, pp. 886-87, 910; Menjivar 1 2, 7, Ex. 37, pp. 997-98, 1045, 1053.) In addition, its CEO, Juan Alexander Arnold, resides in the Central District. (Marino 5, Ex. 33, pp. 886, 915.)

III. THE PARTIES

Plaintiff FTC is an independent agency of the United States Government created by the FTC Act, 15 U.S.C. § 41 et seq. The FTC is charged inter alia, 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.

Defendant **BurnLounge** is a Delaware corporation (Liggins 3, Ex. 14-17, pp. 393, 398-417.) that began making sales in late 2005. (Jackson 6, Ex. 13, pp. 347, 385.) In its first year of operation, BurnLounge was projected to have in excess of \$25 million in revenue, and it had sold 50,000 on-line stores. (Liggins Ex. 15, Ex. 27, pp. 396, 697, 703.)

The four individual defendants all promote the BurnLounge pyramid scheme. (E.g., Gale TT 4-7, Ex. 1-2, pp. 2, 141-167, 219-41, 252-71; Jackson TT 3-6, Ex. 12-13, pp. 346-47, 352-72, 378-90; Liggins 1 6, 15, Ex. 18, 27, pp. 394-95; 422-43, 689-705; Marino 1 2, 5, Ex. 33, pp. 886-87, 894-96, 903-21; Menjivar I 2, 7, Ex. 37, pp. 997-98, 1034-75.) Defendant Arnold is the CEO and Chairman of the Board of Directors of BurnLounge. (Menjivar 4, Ex. 36, pp. 997, 999; Liggins 113, Ex. 15, pp. 393, 403; Gale rif 6-7, Ex. 2, pp. 2, 223-24.) He resides in the Central District of California and is the originator of the BurnLounge concept. (Marino I 2-5, Ex. 33, pp. 886-87, 909, 915.) Defendant Taylor, who is a resident of Houston, Texas, is the number one Mogul in BurnLounge. (Liggins 12, Ex. 24, pp. 395, 608; Jackson 1 5-6, Ex. 13, pp. 346-47, 385.) He was projected to earn \$700,000 through BumLounge in 2006. (Marino I 2, 5, Ex. 33, pp. 886-87, 919.) Defendant DeBoer, is a resident of South Carolina, and has been involved with BurnLounge since late 2005. (Liggins I 6, 10, Ex. 18, 22, pp. 394, 421-422, 441-42, 556; Gale Irg 6-7, Ex. 2, pp. 2, 199, 202, 204.) The final defendant, Scott Elliott, who resides in Dallas, Texas, started with BurnLounge in January 2006. (Jackson 5-6 Ex. 13, pp. 346-47, 378-379; Liggins 7, Ex. 19, pp. 394, 483.)

IV. DEFENDANTS' PRACTICES

A. The BurnLounge Program

Defendants promote their scheme in a variety of ways, including websites, meetings, live

conference calls, and prerecorded messages. The websites contain recorded audio and video messages explaining the program as well as written material such as a description of the BurnLounge compensation program. In addition, the websites contain telephone numbers of prerecorded messages that a customer can call to receive additional information concerning the program. Defendants have also conducted a nationwide campaign of recruitment meetings and telephonic conferences to solicit potential customers.¹

Defendants present the opportunity to participate in the BurnLounge program as a timely way to profit on a shift in technology in the music industry from delivery through media (i.e., compact disks) to delivery in digital format via the Internet. (Liggins 11, Ex. 23, pp. 395, 596; Marino 2, 5, Ex. 33, pp. 88687, 903; Menjivar 2, 7, Ex. 37, pp. 997-98, 1054-59; Liggins Supp. 7, Ex. 41,

¹ This memorandum is supported by seven volumes of exhibits. These exhibits include the following: descriptions of the BurnLounge compensation program and other instructions on how the BurnLounge program works; transcripts of audio promotional material contained on websites; transcripts of prerecorded telephone messages and live conference calls. There are also transcripts of recruitment meetings held in New York, New York, Los Angeles, California, Lawrenceville, Georgia, Deerfield, Illinois and Vienna, Virginia. Finally, there are expert declarations by Dr. Peter Vander Nat who performed a detailed analysis of the compensation plan and the sales materials and concluded that the program is a pyramid scheme. This memorandum summarizes his conclusions, but his declarations, containing more details, are contained at pp. 1173-222 and 1306-10. Specific citations to these materials are provided herein as they are discussed.

pp. 1123, 1153.) Defendants claim that substantial incomes are being made by BurnLounge participants. (See *infra* pp. 12-14.) As validation of the company's offerings, BurnLounge touts its licenses with major record labels to sell music, affiliations with corporate sponsors such as Cadillac and Nokia, and the participation of some music and sports celebrities as BurnLounge retailers, such as Justin Timberlake and Shaquille O'Neal. (Liggins Tig 9, 14, 20, Ex. 21, 26, 32, pp. 394-96, 535-36, 679, 861-62, 879; Marino 2, 5, Ex. 33, pp. 886-87, 894, 907; McKenney Irg 2, 6, Ex. 35, pp. 924-25, 974-75.)

BurnLounge offers product packages for sale at prices that range from \$29.95 to \$429.95 before sales tax.' (Gale 8, 11, Ex. 5, 10, pp. 3-5, 275, 33334; Liggins 2nd Supp. 5, Ex. 47, pp. 1228, 1298-99.) All packages include the right to use proprietary software through which the participant operates an on-line store. Through the on-line stores, BurnLounge sells digital music to consumers. Consumers purchase the music and receive a digital copy by downloading it through the Internet. (Gale Irg 9, 11, Ex. 8, 10, pp. 4-5, 284, 327, 333; Liggins 2nd Supp. 5, Ex. 46-47, pp. 1228, 1250, 1293, 1297.) According to BurnLounge, it has licensed more than two million song titles from independent and major record labels. (Gale TT 4-5, Ex. 1, pp. 2, 87; Liggins 11, Ex. 23 pp. 395, 597.)

There are two basic classes of BurnLounge participants who operate its online stores: "Retailers" and "Moguls." (Gale 9, 11, Ex. 8, 10, pp. 4-5, 287, 328, 333; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1253, 1294, 1297.) All who acquire a product package become a Retailer. (Id.)

Retailers who want to earn monetary rewards must become a Mogul. To become a Mogul, a Retailer must be at least 18 years old and agree to pay an additional monthly fee of \$6.95. (Gale 8-9, 11, Ex. 5, 8, 10, pp. 3-5, 275, 287-88, 313, 334; Liggins 10, Ex. 22, pp. 395,

² In 2007, BurnLounge also began offering a free product package. (Compare Gale 11, Ex. 10, pp. 4-5, 333-34 with Liggins 2nd Supp. TT 3, 5, Ex. 47, pp. 1227-28, 1298.)

560-561; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1253-54, 1299.) Only Retailers who purchase a product package ("a paid product package"), as opposed to acquiring a free one, are eligible to become a Mogul. (Liggins 2nd Supp. TT 45, Ex. 46-47, pp. 1228, 1253, 1299.)

BumLounge offers three paid product packages: (1) the Basic Package, which sells for \$29.95 per year; (2) the Exclusive Package for \$129.95 per year plus \$8 per month; and (3) the VIP Package for \$429.95 per year plus \$8 per month. (Gale 8-9, 11, Ex. 5, 8, 10, pp. 3-5, 275, 312, 333-334; Liggins 2nd Supp. 5, Ex. 47, pp. 1228, 1298-99.) The first \$29.95 charged for each of these product package pays for the on-line store. (Gale 8-11 Ex. 5, 8-10, pp. 3-5, 275, 310, 327, 330, 337.) More expensive packages provide the participant with add-ons such as DVDs about the music industry, downloadable music selected by the company, and preferred seating and entry to select concert venues (Liggins 16, Ex. 18, pp. 394, 437; Gale 4-5, 9, 11, 12, Ex. 1, 8, 10, 11, pp. 2-5, 64, 8990, 327, 333-34, 342-45), but more importantly they provide a participant with an increased ability to earn rewards through the compensation program. (Gale Tif 911, Ex. 8, 10, pp. 4-5, 287-88, 308-09, 312-313, 338; Vander Nat ig 21, pp. 118283; Liggins 2nd Supp. 4 -5 , Ex. 46-47, pp. 1228, 1253-54, 1302-03.) By far the largest rewards for recruitment are provided to Moguls who purchase the \$429.00 VIP package. (Vander Nat, Tif 19, 21-22, pp. 1182-83.) Promoters of BumLounge stress this package (e.g., Liggins 6, 7, 10, 11, 13, 14, 16, 17, 20, Ex. 18, 19, 22, 23, 25, 26, 28, 29, 32, pp. 394-96, 437, 461-62, 566, 569-70, 598, 654, 672-73, 715, 753, 868; Jackson TT 3-6, Ex. 12, 13, pp. 346-47, 355, 385; Liggins Supp. 7, Ex. 41, 43, pp. 1122-24, 1154, 1166-71; Liggins 2nd Supp. 2, Ex. 45, pp. 1227, 1233-34.), as do promotional and training materials. (Liggins 2nd Supp. 3-4, 7, Ex. 39 [encouraging participants to "sponsor, sponsor, sponsor" by hosting weekly "VIP Mixers"], 40 ["V.I.P. package . . . maximizes profits"], 43 ["New VIP Retailer Playbook"], pp. 1139-45, 1147, 1166-71.)

All participants can earn points under the BumLounge compensation program (Gale 9, 11, Ex. 8, 10, pp. 4-5, 307, 316, 335; Liggins 2nd Supp. 45, Ex. 46-47, pp. 1228, 1274, 1300), which has two parts: (1) bonuses for recruitment, and (2) Concentric Retail. (See infra pp. 6-8.) Retailers can redeem the points for purchases through their on-line stores. Only Moguls can redeem the points for dollars. (Gale 9, 11, Ex. 8, 10, pp. 4-5, 307, 316, 335; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1274, 1283, 1300.) For Moguls, one point equals one dollar. (Gale 11, Ex. 10, pp. 4-5, 335; Liggins 2nd Supp. 5, Ex. 47, pp. 1228, 1300.)

i. BurnLounge Pays Recruitment Bonuses.

BurnLounge pays two types of recruitment bonuses. These bonuses are earned from selling BurnLounge packages to new recruits. BumLounge calls these "Product Package Bonuses" and "Mogul Bonuses." (Gale 1[41f 9, 11, Ex. 8, 10, pp. 4-5, 312-313, 337-341; Liggins 2nd Supp. 11

4-5, Ex. 46-47, pp. 1228, 1278-79, 1302.)

There are three Product Package Bonuses, which are earned by selling BurnLounge product packages with the same name. These three bonuses are: (1) the Basic Bonus; (2) the Exclusive Bonus; and (3) the V.I.P. Bonus. (Id.) These bonuses are respectively \$10, \$20, \$50 when paid to Moguls. To qualify to earn Product Package Bonuses, the participant must have sold two albums to non-Moguls in the prior calendar month with the exception that during the first month the requirement is waived. (Gale 119, 11, Ex. 8, 10, pp. 4-5, 308, 338; Liggins 2nd Supp. 114, Ex. 46, pp. 1228, 1275-76, 1278.)

The second type of recruitment bonus is the Mogul Bonus. This bonus is only paid to Moguls and is earned through sales of Exclusive and VIP Packages. (Gale 9, 11, Ex. 8, 10, pp. 4-5, 312-313, 338-339; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1279, 1302-04.) The Mogul Bonus is based on a binary structure. In a binary structure, each participant has a position in the pyramid

immediately below which are two other positions filled by subsequent recruits. As a result, each participant in the binary structure has the potential to develop two teams of subsequent or "downline" recruits. (Vander Nat TT 16, 35, pp. 1180, 1193; Gale 6, 7, 11, Ex. 2, 10, pp. 2, 4-5, 261, 340-41; Liggins 2nd Supp. 45, Ex. 46-47, pp. 1228, 1279, 1304.) The Mogul Bonus rewards a Mogul not only based on his sales of VIP and Exclusive Packages, but also on sales of those packages by that Mogul's downline in the binary structure. (Gale 9, 11, Ex. 8, 10, pp. 4-5, 312-13, 340; Vander Nat 33, p. 1192; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1279, 1304.)

In order to qualify to earn a Mogul Bonus, a Mogul must meet the following one-time requirements: (1) recruit two other participants by selling them either the Exclusive or VIP Package and (2) sell two albums to non-Moguls. (Gale 9, 11, Ex. 8, 10, pp. 4-5, 308-310, 338-339; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1253-54, 1275, 1303.) To remain qualified to earn the Mogul Bonus, the only on-going sales requirement is two albums per month to non-Moguls. The album sales requirement is waived during the first month. (Id.)

Mogul Bonuses are earned through a point system. Sale of an Exclusive Package generates 100 points and sale of the VIP package generates 400 points for the Mogul who makes the sale and for each Mogul in his or her upline (Gale 9, 11, Ex. 8, 10, at pp. 4-5, 312-13, 339-41; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1279, 1304), i.e., Moguls located in a direct line in the binary structure above the Mogul actually making the sale. The points are accrued by the Mogul making the sale and his upline once the new recruit sells two albums. (Liggins 19, Ex. 31, pp. 396, 836-37.) In order to earn a Mogul Bonus, the Mogul must accumulate 300 points in each of the two teams. (Gale 9, 11, Ex. 8, 10, pp. 4-5, 312-313, 340; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1279, 1305.) The amount of the Mogul Bonus varies from \$25 to \$50 depending upon the package the Mogul purchased and in some cases music sales. (Gale 9, 11, Ex. 8, 10, pp. 4-5, 312, 338; Liggins 2nd Supp. IN 4-5, Ex. 46-47, pp. 1228, 1279, 1302.) The Mogul Bonus is a powerful incentive to recruit because it rewards a Mogul for his recruitment and that of his downline.

ii. Concentric Retail

Concentric Retail, the other part of the compensation program, provides rewards for product sales through on-line stores. BurnLounge defines "product" to include digital music downloads, the first \$29.95 of each of the three BumLounge packages, and the \$8 monthly fee paid as part of the Exclusive and VIP Packages. (Gale 9, 11, Ex. 8, 10, pp. 4-5, 310, 337; Liggins 2nd Supp. Tif 45, Ex. 46-47, pp. 1228, 1277, 1301.) As a result, Concentric Retail also provides rewards for recruitment. In addition, Retailers and Moguls earn half a point (500 cents for Moguls) per album sale priced \$9.90 to \$19.79 or 20 percent of BurnLounge's profit margin on the sale, whichever is greater, sold through their on-line stores. (Gale 9, 11, Ex. 8, 10, pp. 4-5, 309, 311, 335-337; Liggins 2nd Supp. 4-5, Ex. 46-47, pp. 1228, 1277-78, 1300-01.) When specified levels of recruitment and product sales are satisfied, Concentric Retail also rewards Retailers and Moguls for product sales by others whom they directly recruit or who are related to them indirectly through subsequent recruitment up to six levels away. (Id.)

iii. BurnLounge Rewards Recruitment Over Music Sales.

BurnLounge provides decisively larger rewards for recruiting than for retail sales of digital music. (Vander Nat Tif 9, 48, 68, pp. 1176, 1203, 1218-19.) For example, while BumLounge pays Product Package Bonuses of \$10 to \$50 for selling the Product Packages, it only guarantees a minimum commission of 500 for the sale of a \$9.90 album. (See supra pp. 6-8.) In addition, BumLounge pays Mogul Bonuses that rewards recruitment. As the binary structure grows through recruiting, the Mogul Bonus dwarfs other forms of compensation. (Vander Nat 9, 48, 68, pp. 1176, 1203, 1218-19.)

The declaration of Plaintiff's expert witness, Peter Vander Nat, Ph.D., demonstrates that the BurnLounge compensation program is constructed to provide much greater rewards from recruitment than for selling music. As part of his analysis, Dr. Vander Nat calculated rewards that would be paid under the BurnLounge compensation program assuming that (1) a new Mogul, John Doe, had purchased a VIP package and satisfied the minimum qualifications to earn Mogul Bonuses by selling two VIP packages and two albums, and (2) each new Mogul who purchased a VIP package from John Doe also bought a VIP package and qualified for the Mogul Bonus in same way and their recruits did the same thing, and so forth. (Vander Nat 1131, Table I, pp. 1190-91.) Under these assumptions, the binary structure would grow exponentially by a power of two. After ten levels of recruitment, John Doe would have 2046 Moguls in his downline (Vander Nat, 32, Table I, pp. 1191), and BurnLounge would pay \$17 in Mogul and Package Bonuses for every \$1 of required retail sales of music. (Vander Nat 119, 46-47, pp. 1176, 1200-01.) Moreover, BumLounge would have to pay \$346 in such bonuses for every \$1 of earnings based on retail sales of music. (Vander Nat 9, 48, pp. 1176, 1203.)

Dr. Vander Nat also examined the relative compensation provided under the BurnLounge compensation program for recruitment and music sales assuming that a VIP Mogul satisfied the requirements of Concentric Retail in order to earn commissions at the highest level, i.e., each participant recruited six new participants and satisfied the music sales qualifications for Concentric Retail to earn at the highest level. (Vander Nat 67-68, pp. 1216-19.) With these

assumptions, Dr. Vander Nat concluded that 90% of the compensation paid under Concentric Retail would arise from product package sales that are part and parcel of recruitment. Using the same assumptions, Dr. Vander Nat also concluded that of the total compensation received by such a participant from recruitment bonuses and Concentric Retail virtually all would be based upon recruitment of others. (Vander Nat 68, pp. 1218-19.) From the foregoing, it can be seen that the BurnLounge compensation program is constructed to provide lopsided rewards for recruitment in comparison to those provided for music sales.

The importance of recruitment over retail sales of music in the compensation program is apparent in promotional and training materials that dwell on earnings from selling product packages and pay little attention to earnings from retail sales of music. (Liggins 2nd Supp. 4, 7, Ex. 40, 43, pp. 1147, 1166-71; see also Vander Nat TT 27-28, pp. 1185-88.) It is also exemplified in the following statements by Defendants DeBoer and Elliott:

Yes, we sell music, but my focus will never be the 99-cent low margin product. It will be the \$440 business that I'm putting people on my team, showing them how to sell music. (Liggins 13, Ex. 25, pp. 395, 654.)

You make a nickel a song, That's why I'm telling you our focus is not the masses on music. (Liggins 116, Ex. 18, pp. 394, 434.)

Is it about driving huge traffic to a website? No, it's not. It's about tying the business community to a brand, then utilizing the sphere of influence of that business community to drive \$20 of business per month. (Jackson 5-6, Ex. 13, pp. 346-47, 383.)

In summary, under the BurnLounge compensation program, music is a low profit item, and it is not the focus of sales. Instead, the focus is on selling the \$440 business, i.e., the VIP package. BurnLounge is not about driving huge traffic to the on-line stores to sell music. Instead, it is about selling the minimum amount of music per month (\$20) in order to qualify for the potentially lucrative recruitment bonuses on the sale of the product packages.

iv. Break-even Analysis

While the compensation plan provides lucrative rewards to a select few for recruiting others, at any point in time the vast majority of BurnLounge Moguls will not have recouped their investment. (Vander Nat 14, 32, 41-43, pp. 1179, 1192, 1198-99.) Again, this is easily demonstrated. Because Moguls pay a monthly fee, their investment increases with time, as does the break-even point. For simplicity and to view the compensation plan in the light most favorable to BurnLounge, we assume that the break-even point is reached during the first month and the amount invested equals the initial outlay to purchase a BurnLounge package. With this assumption and the assumptions from the example about John Doe in the preceding section, it is true that the recruits who populate the bottom three levels of the binary structure will not have recouped their investment. (Vander Nat 41-42, pp. 1198-99.) When there are less than ten levels, the percentage of participants in the bottom three levels is more than 87.5%. (Vander Nat 42 fn. 19, p. 1199.) When there are ten levels or more to the binary structure below the top position, the

bottom three levels contain 87.5% of the participants. (Vander Nat 45 41-42, pp. 1198-99.)

Relaxing some of the assumptions of the foregoing example only increases the rate of those failing to recoup their investment. For instance, the foregoing example assumes optimal recruitment, i.e., all recruits are successful in obtaining balanced recruitment and therefore balanced points. If in reality some recruits fail to achieve balanced points, the percentage of those failing to recoup their investment will be even higher. (Vander Nat 31, p. 1190.) Similarly, the foregoing analysis assumes sales of VIP packages, which is the package emphasized by promoters. (See supra p. 5.) If instead it were assumed that recruits in the downline of John Doe Mogul purchased either the VIP package or the less expensive Exclusive package, the percentage of those failing to recoup their investment would also increase. (Vander Nat 4542 fn. 20, p. 1199.) As a result, it is clear that the vast majority of Moguls will not recoup their investment.³ (Vander Nat iii 42, p. 1199.)

B. Representations Regarding Potential Income

A theme of the presentations regarding BurnLounge is that participants can make substantial income by participating. For example, Defendants have made claims of profitability such as the following at meetings throughout the country as well as during live and prerecorded telephone conference calls promoting BurnLounge or training its participants:

Alex Arnold

[I]f 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 from Texas that can't read. (Marino 7 2, 5, Ex. 33, pp. 886-87, 918-19.)

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. (Gale 7 4, 5, Ex. 1, pp. 2, 162.)

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. . . .

³ The inevitability of losses for those at the bottom of the pyramid does not depend upon saturation having been reached for potential participants. Rather, it exists for whatever time period which is being considered. (Vander Nat 4543, pp. 1199-200.)

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.

(Liggins 457, Ex. 19, pp. 395, 479-80.)

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. (Menjivar If 7, Ex. 37, pp. 998, 1045-46.)

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. (Liggins 6, Ex. 18, pp. 441-42.)

[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. (McKenney 2, 6, Ex. 35, pp. 924-25, 972-73.)

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 thousand of dollars with, frankly, an inferior product. (Liggins Supp. 7, Ex. 41, pp. 1123, 1156.)

Scott Elliott

Our professional BurnLounge team is then available to answer all questions on your behalf until we drive your personal income to \$1,000 per week. (Liggins 11, Ex. 23, pp. 395, 601.)

I'm sitting in this room here in Los Angeles with 40 of the top leaders from across the country, individuals generating 5,000 a week, \$10,000 per week, \$20,000 per week and more in a matter of an eight month period. Now, I'm not saying that's going to happen for everyone. I'm not saying that there's any guarantees here. What I am saying is that you have before you right now today the ability to create wealth in your life. (Jackson 5-6, Ex. 13, pp. 346-47, 388-89)⁴

As set forth in Section V. B, *infra* pp. 17-18, Defendants' income representations are deceptive because the vast majority of participants will not realize such income from the pyramid scheme.

⁴ See also Liggins 8, 10-11, 14, 16-20 (pp. 394-96), Ex. 20, pp. 492, 497-99, 501-02, 509, 519-20 (Taylor: various six and seven-figure incomes), Ex. 22, p. 555 (Taylor: very, very healthy six-figure income), Ex. 23, p. 600 (Elliott: \$20,000 per week), Ex. 26, pp. 678-80 (Taylor: \$1,000 a week to six-figures), Ex. 28, pp. 728-29, 734 (Taylor: \$6,000 a week to \$40,000 a month to six-figures), Ex. 29, pp. 742, 746-48, 756, 759 (Elliott: \$1,000 to \$20,000 per week and more), Ex. 30, pp. 770-71 (Taylor: \$25,000 per week and \$50,000 to \$100,000 per month), Ex. 31, p. 804 (Taylor: low six-figures to high six figures and closing in on seven-figures), Ex. 32, pp. 880-82 (Taylor: \$1,000 a week to \$5,000 a day); Marino 45 2, 5, Ex. 33, pp. 886, 895, 904, 911, 916-19 (DeBoer: six-figure incomes in six months. Taylor: \$1,000 a day. Arnold: "paying people 10, 25, \$50,000 a month"); Liggins Supp. 457, Ex. 42-43, pp. 1123-24, 1163, 1171 (Defendant DeBoer

encourages others to download the "New VIP Retailer Playbook" showing levels of rewards for recruiting through sales of VIP packages, such as \$550, \$6,500 and \$45,000); Liggins 2nd Supp. 112, Ex. 45, pp. 1227, 1241 (DeBoer: potentially earn thousands, tens of thousands, hundreds of thousands).

V. DEFENDANTS HAVE VIOLATED SECTION 5 OF THE FTC ACT

A. Defendants Are Promoting a Pyramid Scheme

BurnLounge is operating a pyramid scheme. (Vander Nat 1114, 50 , pp. 1179, 1203-04; Vander Nat Supp. 452, p. 1306.) Such schemes have an "intolerable capacity to mislead," and "the Federal Trade Commission Act forbids such tactics." *Koscot Interplanetary, Inc.*, 86 FTC 1106, 1180-82 (1975), *aff'd mem. sub nom, Turner v. FTC.*, 580 F.2d 701 (D.C. Cir. 1978). 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 the sale of product to ultimate users." *Koscot*, 86 FTC at 1180 (emphasis in original). Adopting the *Koscot* standard, the Ninth Circuit has stated that the reference in *Koscot* to rewards for recruitment "unrelated to the sale of products to ultimate users" concerns sales to ultimate users outside the pyramid See *Webster v. Omnitrition International, Inc.*, 79 F.3d 776, 783 (9th Cir. 1996). According to the Ninth Circuit, the right to receive rewards for recruitment is the sine qua non of a pyramid scheme.

As is apparent, the presence of the 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.

Webster, 79 F.3d at 781 (quoting *Koscot*, 86 FTC at 1180). "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." *Webster*, 79 F.3d at 782. "Pyramid schemes are said to be inherently fraudulent because they must eventually collapse." *Webster*, 79 F.3d at 781.

In the instant case, the most lucrative rewards offered by BurnLounge are bonuses for recruitment. (See *supra* pp. 8-10.) As demonstrated by Dr. Vander Nat's analysis, if participants do only what they are required to do to earn Mogul Bonuses, BurnLounge would be obligated to pay \$346 in recruitment bonuses for every \$1 of commission on music sales. (Vander Nat 459, 48, pp. 1176, 1203.) Furthermore, even if participants sell more music so that they earn at the highest level of commissions in Concentric Retail, virtually all the rewards they would earn would be tied to recruitment through package sales. (See *supra* p. 10.) Clearly, the BurnLounge compensation program is based primarily on providing payments for the recruitment of new participants not on retail sales of music.

It is also true that the bonuses driving recruitment have no meaningful retail basis in music sales.

(Vander Nat 12, pp. 1178.) The only retail requirement that BurnLounge imposes through its compensation program is the requirement of two album sales per month. (See supra pp. 6-7.) As demonstrated by Dr. Vander Nat's analysis, if participants undertake only what they are required to do, BurnLounge is obligated under its compensation program to pay \$17 in Mogul and Package Bonuses for each \$1 of required albums sales. (Vander Nat 9, 46-47, pp. 1176, 1200-01.) Obviously, the album sales cannot be the funding source of the Mogul and Package Bonuses.' Instead, the source of these monetary rewards is progressive recruitment of new participants. (Vander Nat 4512, p. 1178.) As a result, the recruitment bonuses are not related to retail sales of albums in any meaningful way.⁶ In summary, Defendants promote a pyramid scheme.

⁵ This is especially true in light of the fact that BurnLounge retains only a fraction of each dollar of albums sales because it must pay the cost of the music to the copyright holder. At most, BurnLounge retains its gross margin on such sales. Moreover, BurnLounge represents that it pays 60% of its gross margin as compensation through Concentric Retail leaving only 40% of the gross margin for other uses. (Gale 4-5, Ex. 1, pp. 2, 124; Liggins 4519-20, Ex. 31-32, pp. 396, 828-29, 874.)

⁶ Defendant DeBoer has instructed through a prerecorded voice on demand system that participants can actually give money to others, such as a spouse or a neighbor's child, so they can purchase albums from BurnLounge in order to satisfy a participant's minimum sales requirement. (Liggins Supp. 457, Ex. 41, pp. 1123, 1154-55.) Such sales cannot serve as a basis for showing a relationship between the recruitment rewards and sales to "ultimate users" under Koscot. Sales to a participant, even when disguised, are not sales to an "ultimate users" within the meaning of Koscot. See Webster, 79 F.3d at 783.

B. Income Misrepresentations

Defendants' use of income claims is deceptive. An act or practice is deceptive under Section 5(a) of the FTC Act when "first, there is a representation, omission, or practice that, second, is likely to mislead consumers acting reasonably under the circumstances, and third, the representation, omission, or practice is material." *Cliffdale Associates, Inc.*, 103 F.T.C. 110, 164-65 (1994) cited with approval in *FTC v. Pantron*, 33 F.3d 1088, 1095 (9th Cir. 1994).

Defendants claim that participants have and can make substantial earnings. (See supra pp. 12-14.) Defendants' income claims are misleading because the majority of participants in the pyramid scheme will not breakeven, even if it is true that some BurnLounge participants make the substantial incomes that are described. See *Nat'l Dynamics Corp. v. FTC*, 492 F. 2d 1333, 1335 (2nd Cir. 1974) (where the Second Circuit opined that an advertiser should "not make deceptive use of unusual earnings realized only by a few."); *Five-Star Auto Club, Inc.*, 97 F. Supp. 2d 502, 529 (S.D.N.Y. 2000); see also *FTC v. Arlington Press, Inc.*, 1999-1 Trade Cas. (CCH) 72,415 (C.D. Cal. 1999) ("Even if . . . literally true, a representation will be found to be deceptive and in violation of Section 5 of the FTC Act if its net impression is likely to mislead consumers."). Income claims are also material.

BumLounge is liable for the use of income claims by the individual defendants. This is true because the individual defendants are either actual or apparent agents of BurnLounge. See *FTC v. Goodman*, 244 F.2d 584, 592 (9th Cir. 1957) Alex Arnold, as CEO of BurnLounge, is its actual agent. The other individual defendants, who are all BumLounge participants, are apparent agents when making misleading income claims. If a "consumer believes the agent has been empowered by the principal to make the representations in question," *Southwest Sunsites, Inc.*, 105 F.T.C. 7, 158 (1985), apparent agency exists. In the instant matter, Moguls do not buy inventory for resale. They simply act as barkers to attract business to BurnLounge. To join BurnLounge, a new recruit must register and make payment through the BurnLounge website and enter into an agreement with BurnLounge. (Gale TT 8-10, Ex. 3-10, pp. 2-5, 273-341.) Part of the agreement is agreement to terms stated in several documents, three of which prominently show the BurnLounge name and logo. (Gale 9, 11, Ex. 8, 10, pp. 3-5, 283-329, 332-41.) By causing recruiting Moguls to solicit consumers to purchase a package from BurnLounge and to execute an agreement with BurnLounge, BurnLounge manifests to those consumers that the recruiting Moguls are agents to promote recruitment including making the income claims under consideration. As a result, BurnLounge is liable for the misrepresentation of income made by the individual Defendants.

C. Failure to Disclose

A material omission that is likely to mislead consumers acting reasonably under the circumstances is a deceptive act under Section 5. *FTC v. Pantron I Corp.*, 33 F.3d 1088, 1095. Failing, as Defendants have done, to disclose that the vast majority of participants in a multi-level marketing program have not earned substantial incomes is deceptive in violation of Section 5 of the FTC Act. *Five-Star Auto Club*, 97 F. Supp.2d at 531-32.

D. Liability of Individual Defendants

Defendants Arnold, Taylor, DeBoer and Elliot are individually liable for the violations of the FTC Act described herein. In order to establish their individual liability, it is sufficient for Plaintiff to show (1) that BurnLounge committed deceptive acts or practices in violation of Section 5 of the FTC Act, 15 U.S.C. § 45(a), of a kind usually relied on by reasonably prudent persons and that consumer injury resulted, (2) that the individual defendants participated directly in the wrongful practices or acts or that they had authority to control BurnLounge, and (3) that the individual defendants had some knowledge of the wrongful acts or practices. See *FTC v. Gill*, 265 F.3d 944, 958 (9th Cir. 2001); *FTC v. Affordable Media, LLC*, 179 F.3d 1228, 1234 (9th Cir. 1999); *FTC v. Publ'g Clearing House, Inc.*, 104 F.3d 1168, 1170 (9th Cir. 1997). The FTC need not establish that the individuals possessed the intent to defraud. *Publ'g Clearing House*, 104 F.3d at 1171; *FTC v. Amy Travel Service, Inc.*, 875 F.2d 564, 573-74 (7th Cir. 1989). Nor must the FTC establish that Defendants had actual knowledge of the misrepresentations. Reckless indifference to the truth or falsity of the representations or an awareness of a high probability of fraud coupled with an intentional avoidance of the truth will suffice. *Affordable Media*, 179 F.3d at 1234; *Publ'g Clearing House*, 104 F.3d at 1171.

The FTC need not show that consumers subjectively relied on the representations or omissions to

show resulting injury. "[T]he FTC need merely show that the misrepresentations or omissions were of a kind usually relied upon by reasonable and prudent persons, that they were widely disseminated, and that the injured consumers actually purchased the defendant's products." *FTC v. Security Rare Coin & Bullion Corp.*, 931 F.2d 1312, 1316 (8th Cir. 1991). Such circumstance are present here. The misleading income claims have been widely disseminated by Defendants through meetings in various geographic locations, through telephone conference calls, and postings of prerecorded audio on the Internet, and many consumers have purchased.

Each of the individual defendants participated directly and extensively in the wrongful acts and had the required level of knowledge for liability. Alex Arnold, CEO and Chairman of the Board, is also liable for the additional reason that he had the ability to control BurnLounge. The requisite knowledge can be inferred from the extensive involvement of the individual defendants in the practices under consideration. See *Amy Travel*, 875 F.2d at 574 ("[T]he degree of participation in business affairs is probative of knowledge."); *Affordable Media*, 179 F.3d at 1235. For example, Arnold is the originator of the BurnLounge concept and promotes it. (Gale 4-7, Ex. 1, 2, pp. 2, 138, 141-167, 219-241; Marino IN 2, 5, Ex. 33, pp. 886-87, 909-920; Menjivar 2, 7, Ex. 37, pp. 997-98, 1052-1075; Liggins 118, 12, Ex. 20, 24, pp. 394-95, 517-518, 608-609.) Likewise, the other individual Defendants have extensive involvement. They explain the BurnLounge compensation program (e.g., Gale TT 6-7, Ex. 2, pp. 2, 252-71; Jackson 3-4, Ex. 12, pp. 346, 352-72; Liggins 10, 19, 20, Ex. 22, 31, 32, pp. 395-96, 562-87, 818-21, 871-75; Liggins Supp. in 2, 7, Ex. 38, 42, 43, pp. 112229, 1162-63, 1166-71) recruit and train new participants (e.g., Jackson ligif 3-6, Ex. 12-13, pp. 346-47, 352-72, 378-90; Liggins 6, 15, Ex. 18, 27, pp. 394-95, 42243, 690-705; Marino T52, 5, Ex. 33, pp. 886-87, 894-96, 903-09; Menjivar 2, 7, Ex. 36, pp. 997-98, 1034-48), and use misleading earnings claims. (See *supra* pp. 12-14, 17-18.) Their in-depth involvement evidences the requisite knowledge for individual liability.

VI. THE COURT HAS AUTHORITY TO GRANT THE TRO

The FTC's seeks a noticed ex parte TRO pursuant to Section 13(b) of the FTC Act, 15 U.S.C. § 53(b). The Second Proviso of Section 13(b) provides that "in proper cases the FTC may seek, and, after proper proof, the court may issue, a permanent injunction." The FTC may seek a permanent injunction against violations of "any provision of law enforced by the Federal Trade Commission." 15 U.S.C. § 53(b); *FTC v. Evans Products Co.*, 775 F.2d 1084, 1086-87 (9th Cir. 1985). A routine deception case such as this one, involving misrepresentations of material facts in violation of Section 5 of the FTC Act, is a "proper case." *FTC v. H.N. Singer, Inc.*, 668 F.2d 1107, 1111 (9th Cir. 1982).

Once the equitable power of a federal court has been invoked, the full breadth of the court's authority is available, including such ancillary final relief as rescission of contracts and restitution. *Id.* at 1113. Further, the court may grant a TRO and preliminary injunction, and whatever additional preliminary relief is necessary to preserve the possibility of final effective ultimate relief. *Id.* at 11112. Such relief may include an order freezing assets and an order permitting expedited discovery. See, e.g., *id.* at 1113; see also F.R.Civ.P. 34(b) (allowing the Court to order shortened time for response to request for production). In many previous routine Section 13(b) cases in this district, the Court has entered TRO's including the types of relief

requested here, even when no notice was given.⁷

A. The Evidence Presented Justifies the Entry of a Temporary Restraining Order and Preliminary Injunction

The FTC has submitted strong evidence that establishes Defendants⁷ widespread and systematic deception. Section 13(b) of the FTC Act was designed to combat such abuses. For an agency that acts as "statutory guardian charged with safeguarding the public interest," the standard for preliminary injunctive relief in Section 13(b) is lower than that typically applied to private litigants.⁸ See *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 808 (2nd Cir. 1975). A court in a Section 13(b) action must only (1) determine the likelihood that the FTC ultimately will succeed on the merits and (2) balance the equities. *FTC v. World Wide Factors, Ltd.*, 882 F.2d 344, 346 (9th Cir. 1989); *World Travel Vacation*

⁷ E.g., *FTC v. Connelly*, SACV-06-701 DOC (RNBx); *FTC v. Universa: Premium Services, Inc.*, CV-06-849 SJO(OPx); *FTC v. National Consumer Council Inc.*, SACV-04-0474 CJC (JWJx); *FTC v. Trek Alliance, Inc.*, CV-029270 JSL.

⁸ Irreparable injury, a traditional element for injunctive relief for private litigants, need not be shown. *World Travel Vacation Brokers*, 861 F.2d 1020, 1029 (7th Cir. 1988). "Harm to the public interest is presumed." *World Wide Factors*, 882 F.2d 344, 346 (9th Cir. 1989).

Brokers, 861 F.2d at 1029. In weighing the equities between the public interest in preventing further violations of law and Defendants' interest in continuing to operate their business unabated, the public equities are accorded much heavier weight. *World Wide Factors, Ltd.*, 882 F.2d 344, 346-347; *World Travel*, 861 F.2d at 1030-31. This is particularly true where the evidence demonstrates, as it does here, that a defendant's business is rooted in deception.

The requested relief should be granted in this case. First, the evidence of deceptive practices demonstrates a strong likelihood that the FTC will succeed on the merits. Second, Defendants' violations of a federal statute are continuing, and are likely to continue, unless Defendants are compelled to cease and desist. Third, because Defendants' business is grounded in deception, the equities weigh heavily in favor of granting preliminary relief.

The proposed preliminary relief is reasonable in scope. It prohibits Defendants from operating a pyramid scheme by banning the payment of bonuses relating to recruitment and prohibits the making of deceptive earnings claims and the omission of material information about earnings. The proposed preliminary relief does not prohibit Defendants from engaging in any lawful activity such as the sale of digital music.

B. Order Freezing Assets and Providing Expedited Discovery

A district court's authority to enter orders to preserve the defendants' assets is ancillary to its equitable authority to order consumer redress. In this case, aggregate harm is very substantial and is likely to be millions of dollars. (*Vander Nat li 14*, p. 1179.) The standard for an asset freeze is

a showing of likelihood of success on the merits, combined with a possibility that the assets will be dissipated. *FSLIC v. Sahni*, 868 F.2d 1096, 1097 (9th Cir. 1989) (where the Ninth Circuit held a "likelihood" of dissipation need not be shown). Where business operations are permeated by deception, there is a strong possibility that assets may be dissipated. See, e.g., *Sahni*, 868 F.2d at 1097; *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1106 (2nd Cir. 1972). Thus, courts have ordered such relief solely on the basis of pervasive deception. See *Manor Nursing Centers*, 458 F.2d at 1106; *SEC v. R.J. Allen & Associates, Inc.*, 386 F. Supp. 866, 881 (S.D. Fla. 1974).

Here, there is a likelihood of dissipation, given the pervasive nature of the deception and the substantial monetary liability Defendants face as a result of this lawsuit. An asset freeze is well justified under these circumstances. See *Singer*, 668 F.2d at 1113 (asset freeze appropriate when FTC objective is "to obtain restitution of moneys fraudulently obtained"). A TRO that freezes Defendants' assets would preserve the possibility of full and effective relief for defrauded consumers by preserving the status quo pending a hearing on the preliminary injunction. The requested asset freeze is reasonable in scope and intended to safeguard funds for potential consumer redress without unduly infringing on Defendants. Pending the Court's ruling on an order to show cause whether a preliminary injunction should be entered, Plaintiffs requested asset freeze includes a provision for reasonable living expenses for the individual defendants, as well as a provision allowing the corporate defendant to pay ordinary and necessary operating expenses, but not bonuses and commissions, from frozen assets. In addition, Plaintiff requests that any corporate expenditure in excess of \$3,000 only be allowed if prior approval of the Court is obtained. The requested asset freeze also includes a provision allowing each defendant to pay up to \$10,000 for attorneys' fees related to this matter pending the Court's ruling on an order to show cause whether a preliminary injunction should be entered.

The proposed temporary TRO also contains a requirement for an accounting of assets which is a standard provision of an asset freeze, *FTC v. AmeriDebt, Inc.*, 373 F.Supp.2d 558, 566 (D. Md. 2005). Finally, the TRO provides for expedited the discovery of moneys received by the corporate defendants and the amounts of money paid participants in the form of bonuses for recruitment and commissions for the sale for digital music. It is anticipated at the preliminary injunction hearing a major issue will be the extent to which BurnLounge will be allowed to continue to operate pending a trial on the merits of the complaint for permanent injunction. Central to this issue is the extent to which BurnLounge conducts the legitimate business of selling digital music as opposed to operating a pyramid scheme. The requested financial information is central to this inquiry. It should be readily available to Defendants and easily produced because implementation of the compensation plan would necessitate creation of such records.

VII. NOTICE PURSUANT TO LOCAL RULE 7-19

At the time of this writing, Plaintiff's counsel has contacted or attempted to contact via e-mail and telephone the Defendants in the instant matter and Defendants' counsel, if known, are listed below. Plaintiff's counsel has given notice of Plaintiff's intent to file the Complaint and the application for a noticed ex parte TRO and the types of relief sought through the application. Plaintiff's counsel gave this notice to D.J. Poyfair of Shughart, Tomson and Kilroy⁹, counsel for

BurnLounge, Inc., and Juan Alexander Arnold, and also to Defendants DeBoer and Taylor, personally, who have not yet retained counsel although both Defendants indicated an intent to obtain counsel. Plaintiff's counsel has also attempt to notify Defendant Elliott by e-mail and telephone but has not heard from him at this point. In order to finalize this memorandum for service on Defendants additional information concerning notice and identification of counsel, if any, will be provided by a declaration of Plaintiff's counsel.

VIII. CONCLUSION

This Court should issue the noticed ex parte TRO with conduct prohibitions and asset freeze, order to preserve records and provide business and financial information, and order to show cause why a preliminary injunction should not issue, for the reasons set forth above.

Dated June 5, 2007

Respectfully submitted,

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