11-55687, 11-55699

IN THE

United States Court Of Appeals

FOR THE NINTH CIRCUIT

MEDIFAST, INC., a Delaware corporation,

Plaintiff-Appellant-Cross-Appellee,

BRADLEY MACDONALD, an individual,

Plaintiff-Appellant,

-v.-

BARRY MINKOW, an individual; FRAUD DISCOVERY INSTITUTE, INC., a California corporation; TRACY COENEN, an individual; and SEQUENCE, INC., a Wisconsin service corporation,

Defendants-Appellees,

ROBERT L. FITZPATRICK, an individual,

Defendant-Appellee-Cross-Appellant

On Appeal from the United States District Court
for the Southern District of California
D.C. No. 3:10-cv-00382-JLS-BGS

APPELLEES' PRINCIPAL AND RESPONSE BRIEF

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CORPORATE DISCLOSURE STATEMENT

Defendant-Appellee, Fraud Discovery Institute, Inc., is a California corporation that does not have a parent corporation and no publicly held corporation owns ten percent or more of its stock.

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JURISDICTIONAL STATEMENT

Defendants-Appellees Barry Minkow ("Minkow") and Fraud Discovery Institute, Inc. ("FDI") (sometime together "Minkow"), and Defendant-Appellee-Cross-Appellant Robert FitzPatrick ("FitzPatrick") accept the jurisdictional statement of Plaintiff-Appellant-Cross-Appellee Medifast, Inc. ("Medifast") and Plaintiff-Appellant Bradley MacDonald ("MacDonald").

In addition, FitzPatrick, as Cross-Appellant timely filed on April 27, 2011, his Notice of Appeal of the partial denial of his motion to strike under California's anti-SLAPP statute. Medifast is the only Cross-Appellee because the District Court concluded that MacDonald lacked standing. MacDonald is now deceased.

This brief is submitted jointly on behalf of Minkow, FDI and FitzPatrick as Appellees, and on behalf of FitzPatrick as Cross-Appellant.

STATEMENT OF ISSUES

Did the District Court properly grant Defendants' anti-SLAPP motions to strike MacDonald's claims because he lacked standing to sue; and, does his estate lack standing because he died while the appeal was pending and his personal representatives have not been substituted?

Did the District Court err in concluding that Medifast is not a public figure in evaluating whether Medifast met its burden under California's anti-SLAPP

statute, which would require that Medifast establish a prima facie claim of libel per se by clear and convincing evidence that Defendants' allegedly defamatory statements were made with malice?

Did the District Court properly grant Minkow's and FDI's anti-SLAPP motion to strike because the statements made by them were not provably libelous per se or were subject to immunity?

Did the District Court err in denying part of FitzPatrick's anti-SLAPP motion concerning his opinion that Medifast's multi-level marketing violates California's endless-chain statute, for which the court concluded Medifast had made a prima facie showing of libel per se?

STATEMENT OF THE CASE

Plaintiffs Medifast and its former executive director MacDonald accuse Defendants of defaming them. They contend this was done in internet writings about the publically-traded company's multi-level marketing business model for Medifast's weight-loss program "Take Shape for Life" ("TSFL"). With the exception of one part of Plaintiffs' defamation claim against FitzPatrick, the District Court concluded that none of Plaintiffs' claims survive Defendants' anti-SLAPP motions to strike. [ER 2-3.]

Plaintiffs filed their complaint on February 17, 2010 alleging defamation per se, violation of California Corporation Code section 25400, and violation of

Business and Professions Code section 17200.[1] Defendants are Minkow, FDI and FitzPatrick, and Tracy Coenen and Sequence, Inc. (together "Coenen"). [ER 1.]

Plaintiffs also named as defendants William Lobdell ("Lobdell"), iBusiness Reporting and Zeeyourself, but state they are not parties to this appeal. [Appellants' Opening Brief ("AOB") p.5, n.1.][2]

Plaintiffs filed a first amended complaint adding a claim for civil conspiracy to defame following additional internet statements that Plaintiffs were trying to silence anyone who criticized Medifast's business model for TSFL. All Defendants responded with special motions to strike under California's anti-SLAPP statute. Code of Civ. Pro. § 425.16. [ER 4-5.]

The Court extended the motion briefing schedule at Plaintiffs' request and gave them time for discovery. The Court also allowed Defendants to re-file their anti-SLAPP motions once the discovery period had expired. [ER 280-288.] After two extensions of Plaintiffs' discovery period, Defendants re-filed their motions in November 2010. [ER 289-322 (Coenen); ER 323-356 (FitzPatrick); and, ER 357-382 (Minkow).]

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[1] All statutory references are to the California Code unless otherwise noted.

[2] Although Plaintiffs have abandoned their appeal as to Lobdell and iBusiness Reporting, they were parties to Minkow's anti-SLAPP motion.

Defendants' motions argued that Plaintiffs' complaint is a classic SLAPP suit intended to chill their exercise of First Amendment rights.[3] Under California's anti-SLAPP statute, Plaintiffs' claims must be stricken unless Plaintiffs can demonstrate a probability of prevailing. Defendants argued that Plaintiffs could not make such a showing for many reasons, including: the statements were non-actionable facts; Plaintiffs could not demonstrate that Defendants made false statements and certainly not with malice; Defendants had immunity in republishing on the internet statements of others and their statements were privileged; the derivative claims for market manipulation and unfair business practices depended on constitutionally protected statements; Defendants did not intend to induce stock market activity and, with the exception of Minkow, they did not participate in market activity; and, conspiracy is not an independent tort. [ER 299, 332-335, 364-365.]

The District Court granted Defendants' motions entirely, with the exception of FitzPatrick's motion, which was denied as to one part of the libel per se claim. The court first held that MacDonald did not have standing to sue. [ER 6-7.] It then concluded that Medifast is not a public figure and, therefore, did not have to show by clear and convincing evidence that Defendants' statements were made with malice. [ER 8-13.] However, the Court held that Medifast could not satisfy

[3] "SLAPP" is an acronym for "strategic lawsuit against public participation." *Oasis West Realty, LLC v. Goldman,* 51 Cal.4th 811, 815, n.1 (2011).

even the lesser standard that Defendants' statements were provably false assertions of fact, other than one statement by FitzPatrick that TSFL meets the criteria of an endless chain under California law. [ER 13-20.]

The Court granted all Defendants' motions to strike the remaining claims because there was no evidence to support Plaintiffs' conspiracy to defame claim or their claim for market manipulation under California's Corporations Code; and, Plaintiffs' unfair business practice claim is derivative of their market manipulation and defamation claims, which were stricken, except as to FitzPatrick, and in that regard, there was no evidence that he deceived any reasonable consumer. [ER 21-25.]

Plaintiffs appealed the entire ruling; FitzPatrick cross-appealed insofar as the District Court denied his motion with respect to the libel per se claim. Medifast has waived its appeal of the order striking all claims except the libel per se claim; and, the only issue on appeal involving FitzPatrick is whether MacDonald had standing to bring a libel per se claim. [AOB, p.11.]

STATEMENT OF FACTS

Medifast is a weight loss company that advertises extensively and seeks publicity. It is traded on the New York Stock Exchange ("NYSE"). Until recently, MacDonald was Chairman of the Board. Plaintiffs filed this archetypal SLAPP suit to silence Defendants' criticism of Medifast's multi-level marketing business plan and to discourage further investigations into the meteoric rise of its stock

value and revenue. Their financial bullying is retaliation for Defendants' internet reports and postings critical of Medifast's multi-level marketing program, TSFL. TSFL fueled the spike in Medifast's financial performance while others in the weight-loss industry struggled during the recent recession.

A. Multi-Level Marketing and Endless Chain Schemes

Multi-level marketing (sometimes "MLM") is an increasingly controversial business model. Both California's Attorney General and the Federal Trade Commission ("FTC") have cautioned consumers about MLM companies. The FTC warns consumers to use "a healthy dose of caution" before buying products that offer miracle health, particularly when diet plans are coupled with "opportunities" to become distributors. [Supplemental Excerpts of Record ("SER") 552-553.] Recruited distributors are enticed with commissions or rewards for both their personal sales of the plan's products and those of others they recruit to become new distributers. The right to recruit is extended to new participants in an unending chain with commissions flowing to the top. These MLM programs frequently offer benefits that never materialize, or worse, urge consumers to invest their own money as part of the plan. [SER 552-53.] TSFL's scheme does both.

California's Attorney General explains that there are thousands of variations on unlawful pyramids, and that it is often difficult to tell the difference between a pyramid scheme and a legitimate MLM program. An illegal pyramid or "endless

chain" is a plan "in which a person pays money or buys merchandise for the chance to receive money when additional participants are introduced into the scheme." [SER 560-61.]

Promoters frequently use group psychology to pitch pyramids "at recruitment meetings which create a frenzied, enthusiastic atmosphere where group pressure and promises of easy money prey upon the potential victim's rational mind and fear of missing a good deal." [SER 560.] Pyramid schemes can collapse at any time because there must be an endless supply of new participants for everyone to profit. For as long as they operate, the majority of the last to join suffer losses. The participant's family and friends are typically victims because they too have been recruited. [SER 560.]

Medifast's complaint admits that its subsidiary TSFL combines Medifast's product line with commissioned "health coaches." [ER 30, ¶21.] "TSFL offers its clients an opportunity to increase their income if they chose to become a TSFL health coach." The TSFL client/distributors purchase the "Application Pak or Career Builder Pak" for a cost of $199. "Once certified, health coaches can sell Medifast products to others, and can also, if they choose, recruit other health coaches to join their team." [ER 31, ¶¶ 26, 29.] Health Coaches receive a residual commission "on sales of Medifast products by the recruited health coaches" [ER

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32, ¶32] and a series of reward bonuses [SER 999-1001]. Medifast also hosts annual conventions at resort locations to hype the TSFL program.

Medifasts' spike in revenue coincided with its new TSFL program. In 2010, however, its stock slumped and Medifast delayed its fourth-quarter 2010 earnings report. Since then, Michael McDevitt, the Chief Executive Officer, has left the company. [Request for Judicial Notice ("RJN"), Ex. 1.] Medifast's recent mediocre stock earnings performance confirms what Defendants were saying – that the earlier growth rate in TSFL revenue cannot be sustained as the supply of new Health Coaches diminishes. [RJN, Ex. 2.]

Medifast's alleged damages are not supported by the increase in its stock price during the early stages of the TSFL scheme *after* the alleged defamation. Since then, Medifast's growth rate has suffered because of inherent market limitations. The First Amendment encourages robust discourse about such business practices, particularly if the company's stock is publically traded.

B. Medifast's Obscure History

Medifast was incorporated in Delaware in 2002, and is traded on the NYSE under the symbol "MED." [ER 28, ¶6.] However, the "Medifast" brand name actually was created by Dr. William Vitale in 1980, through a different entity, Jason Pharmaceutical, Inc. ("Jason Pharmaceutical"), for the direct sale of weight loss supplements to other doctors for their patients. [SER 165-67, 174-77.]

Medifast itself was originally known as HealthRite, Inc. ("HealthRite") and changed its name in 2001. [SER 162.] Jason Pharmaceutical is now a subsidiary of Medifast in this corporate shuffle.

In 1992, the FTC filed a complaint against Jason Pharmaceutical because of its advertisements in professional periodicals and consumer publications about the safety and effectiveness of its diet programs. Among the representations challenged were statements that Medifast's "Associate Physicians" were certified in obesity treatment. Jason Pharmaceutical entered a Consent Decree that it would cease making representations without disclosing that proper physician monitoring is required, and unless it possessed competent scientific evidence. [SER 179-199.]

C. MacDonald Perpetuated Medifast's Murkiness

The next year in 1993, Jason Pharmaceuticals filed for bankruptcy. [SER 222-24.] It was eventually acquired HealthRite where plaintiff MacDonald was President and Chief Executive Officer. MacDonald was forced to resign in 1997 after the company suffered severe losses, but he regained control through a proxy fight. [SER 237-41, 255-57.]

In 2001, HealthRite changed its name to Medifast, Inc. [SER 263-64.] In a prospectus for the sale of additional shares, it stated that the Medifast brand "has been recommended by over several thousand physicians" not over 15,000 – 20,000

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as it now states [SER 273] and any mention of the FTC Consent Decree had disappeared. [SER 266-82.]

Two significant events occurred the following year, which were reported in Medifast's 2002 Annual Report to the SEC. One was the creation of Take Shape for Life, Inc., and the other was the initiation of a two-year study by the Johns Hopkins Bloomberg School of Public Health. The study was supposed to compare the effectiveness of Medifast's treatment food for diabetics to a standard American Diabetes Association ("ADA") program. [SER 299, 301.] By this time, Medifast's product had changed from the original liquid protein diet to meal alternatives, and it was implementing TSFL as a new business model. [SER 310.]

The Johns Hopkins' study became a debacle. Based on preliminary results, Medifast announced that researchers had found diabetics on Medifast's meal replacement program lost twice as much as those following the ADA's guidelines. It was learned, however, that Medifast had funded the study, which was delayed by over a year raising further questions. It was reported that only a fraction of the participants had completed the program, therefore the sampling was too small. [SER 314-15, 320, 324-25, 332-33, 623-27.]

During this time, Medifast's stock went through gyrations, quadrupling from $3.79 per share in 2003 to $18 later in the year, only to drop below $3 in 2004. The stock surged again to $20 in 2006, but dropped by over 50% before the end of

the year to less than $10. This happened years before Defendants commented on Medifast's erratic performance. [RJN 2; SER 949.]

In 2006, reports also surfaced that Bradley MacDonald had been using a Yahoo Finance message board to promote Medifast using the pseudonym bradmed@yahoo.com. [SER 320.] He denied the reports, but stepped down as Medifast's CEO in January 2007 under a "succession" plan. He was replaced by Michael McDevitt, son of a military friend and then President and Chief Financial Officer. [SER 317-318.]

During 2006, MacDonald's family and other Medifast insiders unloaded stock amounting to over 5% of the outstanding shares. In just a few months MacDonald and his wife sold $3.7 million in Medifast stock. [SER 326.] The MacDonald's and other board members, including his daughter Margaret, have continued to sell large blocks of Medifast stock ever since. [SER 1111-22, 1124-26.] During a two week period in May and June 2010, MacDonald and his family sold about 173,000 shares valued at over $6 million when the stock rose to an all-time high *three months after Medifast filed its lawsuit claiming its value had been damaged.* [RJN, Ex.3.][4]

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[4] See also, medifast1.com, press releases.

D. Take Shape For Life's Explosive but Unsustained Growth

TSFL took a few years to establish. By mid-2008, however, Medifast's quarterly report to the SEC showed that this "division" increased revenue by 72% over the previous year, accounting for a stunning 41% of Medifast total revenue. During the period, Medifast had an overall revenue increase of 25%. Its main-stay direct marketing division, which accounted for 48% of total revenue, had a revenue increase of only 5%. Doctors accounted for just 3% of revenue and its brick-and-mortar clinics only 7%. [SER 899.] The 2008 year-end results were similar. [SER 602.]

Medifast's historic business structure had been transformed and it was now selling business opportunities inextricably connected with its diet meals through TSFL's multi-level marketing. Little was said about TSFL's business model, but Medifast did state that TSFL's growth correlated to the increase in Health Coaches. The increase followed National Conventions in 2007 and 2008, at resorts where coaches were taught such things as "recruiting." [SER 899.] Meanwhile, TSFL was as opaque as its growth was suspicious.

TSFL's unbelievable revenue surge continued in 2009, when it reported record results. Medifast's overall revenue was up 57% over 2008, while TSFL's revenue increased 107% over the same period in 2008 due to the increased number of "health coaches." TSFL now accounted for about one-half of Medifast's

revenues in a little more than five years. [SER 593.] Meanwhile, Medifast's stock price went from less than $5 in early 2009 to $35 by year's end. [RJN, Ex.2.] Still, little was said about how Health Coaches were actually compensated.

After the lack of information on coaches was raised in FitzPatrick's report, Medifast began to provide Official Income Disclosure Statements for TSFL, which revealed that it has 10 "Ranks" of coaches. For the last half of 2009, the highest rank comprised just .17% of all coaches but their average income was $53,503 *per month*. By contrast, the lowest rank comprised 52.5% of the coaches and their average income was just $97 per month. [SER 337-38.]

Medifast's stock ultimately hit a high of over $35 per share in mid-2010, *after Defendants had allegedly defamed it.* Since then, its stock price has fallen sharply in a classic pattern of an endless chain. [RJN, Ex.2.]

E. Minkow and FDI Initiated an Investigation of Medifast

Barry Minkow co-founded FDI in 2001 to expose fraudulent activity. His interest in educating the public about corporate and consumer fraud stems from his personal history. In the late 1980s and early 1990s, he served seven years in federal prison for securities fraud relating to the carpet cleaning business ZZZZ Best Company. He gained national attention as a Wall Street whiz-kid after starting ZZZZ Best as a teenager and building it into a publically traded company.

[SER 651, ¶¶ 2-3.][5] Minkow was released from federal probation early in 2002 with the support of an Assistant U.S. Attorney who had prosecuted the ZZZZ Best case. [SER 651, ¶3.]

FDI and Minkow exposed over 20 major frauds involving $1.8 billion, working with the Securities Exchange Commission ("SEC"), the Federal Bureau of Investigation ("FBI") and the Internal Revenue Service ("IRS"). He received a letter of commendation in 2005 from the FBI for helping "law enforcement agencies identify and help disrupt and dismantle financial frauds totaling millions of dollars." [SER 651, ¶5; 656-7.] The FBI commented that Minkow's detailed reports helped launch investigations or enhanced pending ones. Minkow has made numerous appearances on television networks speaking about the dangers of corporate fraud and techniques used to deceive victims. [SER, 652,¶7.]

Before discovering Medifast's TSFL business plan, Minkow had a history of responding to consumer inquiries about other MLM businesses. He and FDI previously investigated and issued in reports on multi-level marketers such as PrePaid Legal Services, Inc. and USANA Health Sciences. Through information

[5] Medifast devotes a significant part of its brief to chastising Minkow for his ZZZZ Best conviction, and recent plea bargain in a criminal case for undisclosed transactions involving the stock of home-builder Lennar Corporation. [AOB, pp. 6-9.] Much of what Medifast relies on is inadmissible, but more importantly, there are no SEC charges in this case. Short-selling stock (betting against an increase in value) is not illegal as Medifast implies. However in the Lennar case, Minkow had received inside information that the IRS was going to investigate Lennar before he short sold Lennar's stock. [RJN, Ex.4.]

from others, Minkow learned about TSFL as another possible endless chain recruitment scheme. FDI began to research Medifast, and in mid-2008 hired FitzPatrick to provide an expert opinion. [SER 652, ¶¶7-9.]

F. Minkow Hired FitzPatrick To Investigate and Provide a Report on Medifast

FitzPatrick is a recognized expert on multi-level marketing and pyramid schemes. He co-authored the book *False Profits* published in 1998, which examines the MLM industry.[6] FitzPatrick has worked with government agencies and conducted seminars for the FTC staff and U.S. Postal Service among others.[7] He has been a consultant and expert for the Attorney General or State Attorney in four states, and the U.S. Department of Justice. [SER 19-23, 637-49.]

FitzPatrick has been retained as an expert witness or consultant in various class actions and private actions against some of the best know multi-level marketing companies, such as Nuskin, Herbalife, Keller-Williams, Wellness International Network, Nikken and Pre-Paid Legal. [SER 22, ¶10.]

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[6] FitzPatrick has been on numerous radio programs, including interviews by the British Broadcasting Corporation. He has provided dozens of articles for and been quoted in such publications as the Wall Street Journal, Associated Press, Ladies Home Journal and Money Magazine. His white paper *The Amway Industry,* about influence-buying in the MLM industry and failure of regulators to protect consumers from pyramid frauds, has been circulated among Congressional staff. [SER 20, ¶¶ 8-9, SER 637-49.]

[7] FitzPatrick was the featured speaker at the 2006 annual meeting of the Association of Certified Fraud Specialists and the 2003 National Association of Consumer Protection Investigators.

FitzPatrick published a widely read booklet on the landmark 1975 FTC case against Amway and was an expert witness in the recent consumer class action suit brought against Amway in the Northern District of California. *Pokorney v. Quixtar, Inc.,* No. C 07 0201 (N.D. Cal.), filed January 1, 2007. [SER 21, ¶6, SER 637.] The case alleged that Amway Corporation's successor-in-interest, Quixtar, Inc., operated an illegal MLM pyramid and settled in February 2012, for $55 million in cash and products, with other concessions pushing the settlement value over $100 million. [RJN, Ex.5.] Amway and Medifast have had executives in common. [ER 1001, ¶8.]

FitzPatrick has worked proactively as well with businesses such as Fujifilm, DuPont, Polaroid and Hewlett Packard to develop equitable relationships with their independent distributors.[8]

FitzPatrick alone authored his expert report on Medifast without direction from Minkow or anyone else. He was asked to look at Medifast, apply his expertise and write a report. [SER 90, p.72.] Medifast's assertion the Minkow "authored" FitzPatrick's report is simply not supported by the record. [AOB, p.9.] There was no conspiracy to defame as Medifast contends. FitzPatrick has never met Coenen and has spoken with her rarely about their common interest in fighting consumer fraud. Although he has prepared other expert reports for FDI, he has

[8] FitzPatrick founded "Pyramid Scheme Alert," an international organization that tries to prevent pyramid scheme fraud. [SER 23, ¶ 14.]

met Minkow only once and was not involved in the Lennar investigations. [SER 754-55, ¶¶100-103.]

G. FitzPatrick's Reports and Defendants' Internet Postings

FitzPatrick's initial report was delivered to FDI in September 2008. It was based on Medifast's own financial data and marketing material, from which he opined that TSFL operates as an "endless chain" as defined by California law. FitzPatrick revised his report several months later to include updated information and on February 17, 2009, FDI posted FitzPatrick's report on its website. [ER 52-59, SER 652 ¶¶ 9-10.] FDI had retained other experts to do laboratory testing and forensic accounting, and continued its own investigation until February 2009. [SER 652. ¶¶ 9-11.]

In conjunction with FitzPatrick's report, FDI launched a new website www.medifraud.net, which contained a series of documents related to FitzPatrick's investigation. [SER 652 ¶¶10- 12.] At all times Minkow believed the statements were accurate, and in January 2010, he published an open letter to Medifast and its board of directors offering to retract his statements and apologize if they could identify any factual inaccuracies. He received no response. [SER 653, ¶¶ 13-14.]

Minkow also delivered a letter to the FTC and the California Attorney General advising them of FitzPatrick's and FDI's findings about Medifast.

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FitzPatrick's report was included to induce the government agencies to open their own investigations, as FDI had done in the past. [SER 653, ¶15.]

H. The Factual Basis for FitzPatrick's Opinions

FitzPatrick confirmed in his updated February 2009 report that his analysis focused on the TSFL's multi-level marketing business model. He categorized Medifast as a MLM company because, by the third quarter of 2008, TSFL accounted for over one-half of Medifast's revenue. [ER 53-54.] At the beginning, FitzPatrick states that his report "examines and offers an opinion" whether TSFL operates as an endless chain as defined by the California Penal Code. He opined that it did because, among other things, it used a business model that paralleled Your Travel Business.com ("YTB"), which had been prosecuted by the California Attorney General. [ER 54.]

He explained that in the post-Madoff era "extraordinary and singular growth by a company must be viewed as a cause for scrutiny." FitzPatrick invites a careful look at such companies where sudden revenue growth is not explained by "technological superiority, overall industry growth or any other verifiable market factor" which "now should be reasonably questioned as a possible signal of pyramid fraud." [ER 54.]

FitzPatrick's opinions and words of caution were based on Medifast's corporate disclosures and public information. As TSFL's sales grew 99% over the

previous year, the weight-loss industry struggled and the Dow Jones Industrial average sank almost 40%. [SER 943.] Medifast attributed its growth to TSFL but rationalized that consumers are more health conscious in difficult economic times, and can supplement income through direct sales in TSFL. [ER55.] While Medifast boasted publically about the recession-defying revenue spikes of TSFL, it disclosed little about the actual incomes, costs, drop-out rates or commission distributions among the multiple levels of its Health Coaches. [ER 59.]

Medifast acknowledged in 2009, that it offered consumers business opportunities by becoming TSFL Health Coaches. For $99 they could purchase a Starter Pak or for $299 they could buy a Career Builder's Pak. [AOB 13, n.6.] Those who paid the higher amount got a 33% higher commission rate when they enrolled additional coaches.[9] New coaches also got a $100 "client acquisition bonus" for recruiting five new clients within 30 days. The clients could be new coaches or consumers or a mixture of both. Those who bought the $299 Pak got another "assist bonus" of $100 each time one of their recruits did the same thing. [ER 62.] The bonuses induced up-front investment and incentivized recruitment.

FitzPatrick observed that while Medifast's web-site had charts showing health coaches could make $8,000 to $20,000 per month, nothing was said about average income, especially for those at the lowest levels. [SER 24, ¶¶12-13.] His

[9] Medifast has since changed the buy-in amount for Health Coaches to $199. [ER 1014, ¶51.]

investigation showed that only 1% had average monthly incomes above $8,000, which was confirmed when Medifast finally filed its 2009 and 2010 Income Disclosure Statement. [SER 821, 912 & 948.]

The Income Disclosure Statements also verified FitzPatrick's determination that the lowest levels of TSFL's Health Coaches generated most of the revenue and growth, but received the least compensation. This has contributed to high attrition and the constant need to recruit new coaches.

1. The Court Rejected All But One Claim That Plaintiffs Were Defamed

The District Court had little difficulty rejecting all but one of Plaintiffs' contentions that they had been defamed, finding that Medifast did not plead the exact works constituting the alleged defamation.[10] Instead, the court found that Medifast had paraphrased Defendants' statements for maximum shock value. [ER 15:1-9.] Of the 37 allegedly false statements that Medifast identified, the court found that most pertained to TSFL's compensation system, which are not defamatory without explanatory information.

However, the judge identified three categories of statements requiring closer scrutiny: (1) that TSFL's business model and reward system meet the definition of an "endless chain" under section 327 of the California Penal Code; (2) that the

[10] The Court analyzed whether Defendants' statements were libelous *per se* because that is what Defendants' alleged in their complaint. [ER 6, n.4.]

comparison of TSFL to Bernie Madoff implied a provably false statement that Medifast is running a Ponzi scheme; and (3) that Medifast was accused of committing securities fraud through collusion with its accounting firm by pumping its stock to their clients. [ER 15-20.]

The District Court ultimately concluded that Medifast had established a prima facie case as to only FitzPatrick and the statement that in his opinion TSFL met the definition of an "endless chain" under California law.

In deciding that Medifast had stated a prima facie claim against FitzPatrick, the court relied on the declaration of Daniel Bell ("Bell"), who claims to be an architect of TSFL's compensation plan. The court said that FitzPatrick did not present evidence to rebut Bell's declaration. [ER 16:21.] However, evidence before the District Court shows that, although TSFL's compensation scheme is cleverly disguised, it has all of the elements of an endless chain.

2. Medifast's Expert is Rebutted by Evidence in the Record

Bell misled the District Court. He directed the court away from the explicit language of California's statute, into an analysis more suited to the complexities of section 5 of the Federal Trade Commission Act. 15 U.S.C.A. § 45(a) & (n). That section, however, applies to a broad range of deceptive practices, including

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pyramid schemes, which are not specifically identified.[11] FitzPatrick did not say that Medifast violated the FTC Act, even though it does, but instead that TSFL meets the definition of an endless chain under California's Penal Code, section 327. [ER 54.]

Section 327 defines an "endless chain" to be "any scheme for distribution of property" where a participant "pays a valuable consideration for the chance to receive compensation" for introducing "additional persons into participation into the scheme" or "when a person introduced by the participant introduces a new participant."

Bell dodges this straightforward definition and obfuscates the analysis with a barrage of selective data and figures, which he said were "proprietary." [ER 1003, ¶16.] His primary point was that "the focus of TSFL health coaches is more towards client acquisition, not recruiting other health coaches." California's statute, however, does not weigh the primary focus of the MLM scheme, but instead whether it meets the criteria of an endless chain. Bell also inaccurately paraphrases FitzPatrick's report, and presents argument as much as facts.[12]

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[11] An FTC staff report notes that identifying pyramid schemes masquerading as multi-level marketing requires a complex economic analysis under federal law. *Disclosure Requirements and Prohibitions Concerning Business Opportunities Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule* (16 C.F.R. Part 437, p. 21, n. 60 (2008).)

[12] Bell has a strong interest in perpetuating the TSFL scheme. He, together with Wayne Anderson, the co-founder of TSFL, and their wives Lori Anderson

Bell states that in 2002 Medifast hired him to help with the acquisition of TSFL's "predecessor company" Health Inventions, Inc.[13] [ER 1000, ¶2.] Since then he claims to have become an "independent health coach" with TSFL. He parlayed that *in just six years* into his capacity as a TSFL Presidential Director, the highest Health Coach level, which paid on average $642,036 per year in 2010.

a. Health Coaches Pay for the Right to Sell Medifast and Receive Compensation for Recruiting New Coaches

According to Bell, Health Coaches focus on clients, not recruiting, by getting them to eat Medifast products and teaching them lifestyle changes – for which the clients do not pay the Health Coach. [ER 1005, ¶22.] This begs the question how do Health Coaches make any money? Bell says the coaches get paid when clients make *direct purchases* of Medifast products from the coach. A person could, of course, purchase Medifast products without a coach, but then no

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and Mary Bell run TSFL's Trilogy Training Systems, which generates the training materials required by Health Coaches. (www.trilogytrainingsystems.com.) In addition, both the Bells and the Andersons are in the highest level of TSFL's coaches, who earn *an average of $53,000 per month* according to TSFL's 2009 Official Income Disclosure Statement. [SER 337.] Bell and his wife are former Amway distributors. [ER 1001 ¶8.]

[13] Kevin Keranen was the President of Health Inventions when Medifast acquired it. Keranen later became a founder of BurnLounge, Inc. which was prosecuted by the FTC as another pyramid scheme. *Federal Trade Commission v. BurnLounge,* No. CV 07-3654-GW (C.D. Cal. 2006). Copies of the recent Statement of Decision and Amended Judgment are attached to the Request for Judicial Notice. [RJN, Exs. 6 & 7; see also SER 571.]

commission would be paid. [1006, ¶¶ 23-25.] So, to make any money a person must become a Health Coach and to become a Health Coach, a fee must be paid.

A Health Coach must be sponsored by a "Business Coach." Until the fee is paid and the Health Coach is "trained" they cannot receive commissions. Business Coaches in turn are trained by "Business Leaders." Each level cultivates clients, but unless Health Coaches enlist more Health Coaches their income will be limited to their personal sales. When sales are made, the Health Coach *and* the Business Coach make money. [ER 1007, ¶29.] The percentage of commission drops as coaches move up the levels, but the volume more than makes up for it as the expanding chain capitalizes on the sales of down-line coaches.[14] [ER 1007, ¶30.] Those at the bottom, however, made only an average of $96.90 per month in 2009. [SER 337.]

His point that most product orders are placed by clients, not Health Coaches, misses the issue. The salient fact in Bell's declaration is that Medifast distributes its products through a scheme whereby the Health Coaches pay consideration for the chance to obtain commissions by introducing more Health Coaches. That is prohibited by California's endless chain law.

[14] Bell analogizes the levels of coaches to a medical practice in a clinic, which is entirely different. A doctor's business is to sell services, not products manufactured by the MLM entity; and, a doctor's compensation does not include commissions from newly recruited doctors, who themselves can further recruit new doctors *ad infinitum* after they pay some consideration for the right to commissions.

b. Health Coach Attrition Reveals the Endless Chain

As FitzPatrick stated in his 2009 Report, Medifast had not disclosed in its SEC filings the financial condition of coaches, the turn-over rate, or the business costs incurred. TSFL instead was enticing new layers of Health Coaches on its website by showing the disparity in income potential between a "Client Focused" and a "Client & Team Building Focused" strategy. [ER 78; SER 938.] The "client" strategy would generate monthly income between $100 and $7,500 per month and then plateau. By contrast, the "client and team building" strategy would generate between $1,000 and $25,000 per month and thereafter escalate vertically. [ER 78.]

Similarly, Bell did not tell the District Court essential information about the attrition rate of Health Coaches and led the court to believe that the number of coaches was rapidly expanding. [ER 1008-09, ¶¶33-34.] He states that from May 2009 through April 2010, TSFL added 6,356 new Health Coaches, and that as of May 2010, the total number of coaches was 8,000. However, he does not disclose that Medifast already had 4,000 coaches at the beginning of the period. [SER 746, ¶¶64-64; RJN, Ex.8, p.13.] That meant 2,356 coaches had quit – a remarkable 60% attrition rate.

The flurry of numbers Bell recited to the District Court has little significance under California's statute. The ratio of recruited Health Coaches to clients, or of

retail sales to internal sales, does not matter. Medifast charges a fee for the right to recruit and compensation is received from those recruited who are offered the same business opportunity for the same right. This recruitment-based incentive scheme includes purchases of Medifast products by the Health Coaches themselves, for which the up-line coaches receive commissions. This meets the definition of an endless chain under California law, and would under FTC case authority as well.

c. Bell Manipulated Data to Obscure the Endless Chain

California's endless chain statute prohibits schemes where participants pay for the chance to receive compensation for bringing others into the scheme, or when a person introduced brings in a new participant. Medifast's assertion that some new Health Coaches might make more from sales than recruiting is irrelevant. Nevertheless, Bell diverted the District Court with misleading data on the source of income for the Health Coaches.

Of the ten levels of Health Coaches, Bell focuses on the fifth rank of "Executive Director" which comprised 6% of all coaches in 2010. [SER 337 &948.] Bells says that 90% of those who reach that rank do so based on sales and not on recruiting, which he calls "structure." He uses this to state that "building structure is not the dominant driver of the TSFL business model." [ER 1020, ¶74.] While California's statute does not consider the "dominant" source of compensation, the full story is much different than Bell implies.

Executive Directors are a relative low level Health Coach, made up mostly of new participants, who have recruited 5 other coaches or sold to 25-30 customers. [ER 1019, ¶¶ 72-73.] While 96% of all Health Coaches are Executive Director rank or lower, they receive only 56% of the commissions. [SER 337 & 948.] On the other hand, the top 4% receive 44% of all commissions, with the top 1% receiving about 28%. [SER 748, ¶70.] Bell says nothing about dominant source of compensation for those few in the top ranks, nor why their participation in the scheme would not be part of an endless chain.

In addition, because the vast majority of Health Coaches are at the lowest levels, their compensation would be primarily sales because they have not had time to build a down-line of recruits. With a drop-out rate of 60%, few remain to build any structure.

Bell also fails to address the sales made to Health Coaches themselves. He admits that in 2009, 13% of purchases were made by coaches. [ER 1015, ¶56.] These internal transactions are included as part of the revenue from sales, but they come from the down-line structure. In effect, sales and recruitment are not mutually exclusive as Bell implies.

Medifast's facts do not establish a prima facie case of defamation per se because they did not show that Defendants statements' were false. To the extent they tried to make a showing, the evidence rebuts their facts, particularly when put

in the context of a more comprehensive explanation. Bell's confusing declaration shows the insidiousness of endless chains, and misled the District Court.

I. Comparisons of Medifast to Madoff Are Not Defamatory

The District Court considered, but rejected, whether two other categories of statements were defamatory: first, that the comparison of TSFL to Bernie Madoff implied a false statement that Medifast is running a Ponzi scheme; and second, that Medifast was accused of committing securities fraud through collusion with its accounting firm by pumping its stock to their clients. On appeal, Plaintiffs only question the court's conclusion that the Madoff comparison was not libelous, and they only do so as to Minkow. [AOB 42-49.]

The District Court concluded that "Defendants' statements cannot reasonably be understood to imply the provably false assertion of fact … that Medifast is running a Ponzi scheme." [ER 19:18-20.] "Defendants did not accuse Medifast of running a Ponzi scheme simply by using "Medifast" and "Madoff" in the same breath." [ER 19:24-25.]

Medifast relied on the internet-post "Points of Similarity Between Madoff and Medifast" in arguing defamation. [ER 88.] However, as the court concluded, a comparison of similarities between Medifast's TSFL business model and Madoff's activities for purposes of debate and consideration is not defamation.

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J. Medifast Seeks Exposure Through Public Controversies

In considering whether Plaintiffs had made a prima facie case of defamation, the District Court decided that Medifast was not a public figure and, therefore, did not have to prove malice by clear and convincing evidence. [ER 13:25-26.] Medifast, however, has for many years aggressively pursued publicity on the issue of treatment for obesity and diabetes. More recently, it has coupled that publicity with its TSFL scheme as a way to generate income through multi-level marketing of Medifast products. [SER 701-27.]

In 2009, Medifast's 10k Report to the SEC stated advertising expenses of $17.8 million for the year, and $18.4 million for 2008 when Defendants began their investigations. [SER 1035, Operating Expenses.] Medifast highlights the "obesity epidemic" and a study by the American Medical Association showing that 70% of American adults are obese or overweight, and that obesity in children has tripled. [SER 997.]

Medifast leverages its brand through several marketing strategies. This includes national advertising in print and broadcast media, as well as strategic public relations through local and national editorial placements. It previously contracted with two celebrities for marketing campaigns, and added a third in 2009. [SER 1017.]

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Regarding TSFL, Medifast knowingly engages in controversial business and marketing methods. It acknowledges, in its restated 2009 10-K to the SEC, the risk that its selling method might be interpreted to be a "pyramid" or "chain sale" scheme. [SER 1021.] Nevertheless, it issued press releases touting its success in bucking industry trends led by TSFL using "multi-level marketing techniques." [SER 593-94, 602-03, 608, 614-615.]

When FDI posted FitzPatrick's report on its website, Medifast immediately issued a press release, joining the issue and announcing a conference call to discuss the report. [SER 620.] Medifast wrongly attributed the report to Minkow who it calls a convicted felon.[15] Medifast issued another press release in January 2010, the month before filing this lawsuit, again attacking Minkow and upping the stakes by filing complaints with the federal and state governments. Two days, Medifast announced that it had lodged a complaint with the SEC and Maryland's Securities Commissioner. [SER 629, 634.]

Medifast has thrust itself into the public eye with multi-million dollar advertising campaigns every year. It seeks to capitalize on the obesity epidemic and controversy over the best treatment methods. Medifast has increased its public exposure by resorting to a controversial MLM business model to grow its product-line, knowing it could be found to be an endless chain or pyramid scheme. When

[15] Medifast typically issues more than a press release per month. [See, medifastdiet.com/pressreleases.]

questioned about the sale of its products through suspicious multi-level marketing, Medifast retaliates through the public media.

K. Defendants Did Not Engage in a Conspiracy, Market Manipulation or Unfair Business Practices

The District Court also granted Defendants' anti-SLAPP motions to strike Plaintiffs' claims for conspiracy, and violations of the Corporations Code and the Business and Professions Code. [ER 22-25.] Plaintiffs present no argument on appeal to provide a basis for reversing the court's ruling on those claims. Although Plaintiffs suggest in their factual statement that some similarity exists between those claims and Minkow's federal prosecutions in the ZZZZ Best and Lennar cases [AOB 6-9], the allegations were different and have no effect here.

Should this Court determine that Plaintiffs have not waived their appeal on the claims, they still have not presented any evidence to support a conspiracy claim. [ER 22:10-12.] Neither FitzPatrick nor Coenen ever traded in Medifast stock [SER 17, ¶3; 518, ¶23] so no conspiracy could exist with Minkow assuming he did intend to devalue Medifast's stock.

Plaintiffs also have not presented evidence that they bought or sold securities to support their claim of market manipulation in violation of Corporations Code section 25400. The District Court again held in this regard that Plaintiffs did not establish a likelihood of success. [ER 23:15-23.]

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Plaintiffs' other claim for unfair business practices in violation of Business and Professions Code section 17200 is derivative of their other claims. Because Plaintiffs did not provide evidence to support any claims against Minkow and Coenen, the only issue was whether the defamation claim would provide a predicate for an unfair business practices claim against FitzPatrick. The court again rejected Plaintiffs' contention that there was collusion among the Defendants to support the claim. [ER 25:2-7.] In their factual statement, Plaintiffs now contend that Minkow "authored" FitzPatrick's report, however, the record cited does not support their contention. [AOB 9.] Thus, as the District Court concluded, "Plaintiffs fail to establish that FitzPatrick's report was likely to deceive a reasonable consumer." [ER 25:5-9.]

Plaintiffs have waived the appeal of their conspiracy, market manipulation and unfair business practices claims by not presenting any argument. At best, they made references to limited facts that are not supported by the record or pertain to other cases involving different law and issues.

STANDARDS OF REVIEW

Minkow and FitzPatrick agree with Medifast that a district court's decision to grant an anti-SLAPP motion is reviewed *de novo* (*Price v. Stossel,* 620 F.3d 992, 999 (9th Cir. 2010)) and that the issue whether a party has standing is

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reviewed *de novo* (*Fair Housing of Marin v. Combs,* 285 F.3d 899, 902 (9th Cir. 2002)).

Minkow and FitzPatrick disagree with Plaintiffs that federal procedural law applies to anti-SLAPP motions to strike. Although federal courts in diversity actions generally apply state substantive law and federal procedural law (*Erie Railroad Co. v. Thompson*, 304 U.S. 64, 78 (1938)), California's anti-SLAPP laws are substantive under the *Erie* doctrine because they do not conflict with Federal Rules. *United States ex rel. Newsham v. Lockheed Missile & Space Co., Inc.*, 190 F.3d 963, 973 (9th Cir. 1999).

A trial court's determination of disputed facts concerning a party's public figure status is reviewed for substantial evidence, while resolution of the ultimate question of public figure status is subject to independent review for legal error. *Khawar v. Globe Intern., Inc.,* 19 Cal.4th 254, 264 (1998), citing *Wolston v. Reader's Digest Ass'n, Inc.,* 443 U.S. 157, 166-168 (1979).

SUMMARY OF ARGUMENT

California's anti-SLAPP statute was designed to discourage Plaintiffs like Medifast and MacDonald from using financial power to silence free speech through threats of economic ruin. Plaintiffs have succeeded in muting their critics despite losing the special motions to strike as to every claim, with the exception of a single claim for defamation against FitzPatrick. Plaintiffs should have lost on

FitzPatrick's motion as to that claim as well, but in the process they chilled further criticism of their exploitive business model because the stakes for questioning it are too high. FitzPatrick was right though – Medifast's multi-level marketing scheme for TSFL is an endless chain. The critical point is that Plaintiffs cannot establish a probability of success on their libel per se claim against him.

The only claim before this Court is Plaintiffs' claim for libel per se. Plaintiffs have waived the appeal of their other claims for conspiracy, market manipulation, and unfair business practices by not presenting argument, much less a basis for reversing the District Court's order. As to MacDonald, Plaintiffs state that the only issue involving him is whether he had standing to bring a libel per se claim. [AOB, p.11.]

As the District Court concluded, MacDonald did lack standing. In the face of the First Amendment's broad protection of discussions on public matters, MacDonald could not show that any allegedly defamatory statements specifically identified him. MacDonald failed to meet the test for establishing standing because Defendants' statement could not be understood as referring to him personally; and, no reasonable third party would understand them that way. The few statements that mention MacDonald, did not defame him. MacDonald's new effort to draw an elaborate connection between Defendants' statements and internet postings by third parties fails to show any reference to him, certainly not

one that a reasonable third party would understand. Apart from that, MacDonald is now deceased and his personal representatives have not sought standing.

The District Court did err, however, by not identifying Medifast as a "public figure." Public figures must prove defamation by "clear and convincing evidence" of defamatory statements made with "malice." Even though the court granted Defendants' motions to strike as to all claims but one, that claim would have been stricken too had the public figure standard been used. Medifast spends tens of millions of dollars every year publically promoting itself. It has injected itself into the growing controversy about the country's obesity epidemic using TSFL's unrealistic growth as proof that its products are the solution. Medifast identified its TSFL marketing method as instrumental because it uses "Health Coaches" while acknowledging in public filings that TSFL instead could be challenged as a pyramid scheme. Medifast is a limited purpose public figure and it offered no evidence that Defendants defamed it maliciously.

As to Minkow, the District Court concluded that even using the lesser evidentiary standard, Medifast did not establish a probably of succeeding on its libel per se claim. Medifast now argues that Minkow should be held accountable for FitzPatrick's statement that TSFL operates as an endless chain, which the court held was a basis for a libel per se claim, because Minkow republished it. However, the federal Communication Decency Act grants immunity for republishing on the

internet. In addition, Minkow's actual statements could not be understood as implying a provably false assertion of fact. Medifast now relies on a series of exhibits to its complaint to remedy the lack of specific factual pleadings, but it still cannot identify provably false facts. Medifast also fails to overcome its defective pleadings, by arguing that the court used the wrong pleading standards. The *Erie* doctrine, which typically applies state substantive laws and federal procedure laws in diversity actions, does not govern where states enact specific procedures such as California's anti-SLAPP statute.

Finally, the District Court was misled, concluding that Medifast had established a probably of prevailing on its libel per se claim against FitzPatrick. In that regard, the court erred. Medifast convinced the court to apply the wrong law in evaluating whether FitzPatrick had made a provably false statement. Instead of considering only California's endless chain statute, the court adopted Medifast's analysis based on the more narrow definition of a "pyramid" scheme used in some FTC cases. The court, therefore, reasoned incorrectly that because no compensation was paid to participants merely for recruiting, it was not an endless chain. The proper issue, however, is whether part of the compensation was paid for recruiting, which it was. Additionally, because Medifast pays rewards that are unrelated to sales of products to ultimate users, TSFL also satisfies the FTC definition.

Regardless, FitzPatrick rebutted Medifast by showing that although its evidence was cleverly presented, Medifast admits the elements of an endless chain. When FitzPatrick provided missing information, such as the attrition rate of low-level participants and the gross disparity in income through the ten ascending levels of TSFL's scheme, the endless chain became clear.

ARGUMENT

This case presents timely issues about use of the internet to address important questions of public interest without fear of lawsuits being brought to silence the exercise of free speech.

I. The Purpose and Application of California's anti-SLAPP Law

California's Legislature enacted the anti-SLAPP statute out of concern about the disturbing increase in lawsuits aimed at preventing citizens from exercising their political rights or punishing them for doing so. *Simpson Strong-Tie Co. Inc., v. Gore,* 49 Cal.4th 12, 21 (2010). California's anti-SLAPP statute provides:

> A cause of action against a person arising from any act of that person in furtherance of the person's right of petition or free speech under the United States Constitution or the California Constitution in connection with a public issue shall be subject to a special motion to strike, unless the court determines that the plaintiff has established that there is a probability that the plaintiff will prevail on the claim.

Code of Civ. Proc. § 425.16(b)(1).

The statute authorizes use of special motions to strike to expedite the early dismissal of unmeritorious claims. It is broadly construed to encourage continued

participation in matters of public significance. *Simpson,* 49 Cal.4th at 21, citing § 425.16, subd. (a).) "'While SLAPP suits masquerade as ordinary lawsuits such as defamation or interference with prospective economic advantage, they are generally meritless suits brought primarily to chill the exercise of free speech or petition rights by the threat of severe economic sanctions against the defendant, and not to vindicate a legally cognizable right.'" *Id.,* citing, *Castillo v. Pacheco,* 150 Cal.App.4th 242, 249-250 (2007), quoting Sen. Com. on Judiciary Analysis of Sen. Bill No. 1296 (1997-1998 Reg. Sess.).

An anti-SLAPP motion to strike involves two steps. "First, the defendant must make a prima facie showing that the plaintiffs' suit 'arises from an act in furtherance of the defendant's rights of petition or free speech.' (Citation omitted.) 'Second, once the defendant has made a prima facie showing, the burden shifts to the plaintiff to demonstrate a probability of prevailing on the challenged claims.'" *Mindys Cosmetics, Inc., v. Dakar,* 611 F.3d 590, 595 (9th Cir. 2010), citing *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1110 (9th Cir. 2003).

The burden a plaintiff must carry in opposing an anti-SLAPP motion has been described by the California Supreme Court:

> [T]he plaintiff must demonstrate that the complaint is both legally sufficient and supported by a sufficient prima facie showing of facts to sustain a favorable judgment if the evidence submitted by the plaintiff is credited. In deciding the question of potential merit, the trial court considers the pleadings and evidentiary submissions of both the plaintiff and the defendant; though the court does not *weigh* the

> credibility or comparative probative strength of competing evidence, it should grant the motion if, as a matter of law, the defendant's evidence supporting the motion defeats the plaintiff's attempt to establish evidentiary support for the claim.

Manufactured Home Communities, Inc. v. County of San Diego, 655 F.3d 1171, 1176-1177 (9th Cir. 2011), citing *Wilson v. Parker, Covert & Chidester,* 28 Cal.4th 811, 821 (2002), *superseded in part by statute.* "The applicable burden 'is much like that used in determining a motion for nonsuit or directed verdict, which mandates dismissal when no reasonable jury could find for plaintiff.'" *Mindys,* 611 F.3d at 599, quoting *Metabolife Int'l, Inc. v. Womick*, 264 F.3d 832, 840 (9th Cir. 2001).

Plaintiffs concede that the suit arises from Defendants' statements in furtherance of their rights of free speech. The remaining question is whether Plaintiffs established a probability of prevailing on their claims. They did not. The declaration of Bell, upon which they rely, itself reveals that a fundamental part of Medifast's compensation scheme for TSFL is an endless chain. When Medifast's mathematical manipulations are eliminated and Defendants' rebuttal evidence is considered, the endless chain is unmistakable.

II. California Pleading Rules Apply in Deciding an anti-SLAPP Motion to Strike a Libel Per Se Claim

The District Court applied California law in evaluating whether Plaintiffs met their burden of demonstrating a probability of prevailing. The court found it

problematic that Plaintiffs did not plead the exact words constituting the alleged defamation, citing *Christakis v. Mark Burnett Prods.*, 2009 WL 1248947, at *4 (C.D. Cal. Apr. 27, 2009).[16] Instead, as the court explained, Plaintiffs paraphrased Defendants' statements for maximum shock value.

Of the thirty-seven allegedly defamatory statements identified by Medifast, the court found that nearly all regard "the structure and function of TSFL's compensation system" which "do not charge Medifast with commission of a crime, nor are they otherwise defamatory without the necessity of explanatory matter." [ER 14-15.] The court concluded that Defendants' statements do not constitute libel per se, with the exception of the endless chain comment.

Medifast challenges the District Court's application of California law in reaching its conclusion, arguing that federal procedural law governs. [AOB, p.34.] The law is different in this case. The general rule is that federal courts exercising diversity jurisdiction normally apply the substantive law of the state and that procedural issues are governed by federal law. *Erie Railroad Co. v. Thompson*, 304 U.S. at 78. However, where there is no federal rule, state procedural rules may

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[16] *Christakis* cites both state and federal authority: *Des Granges v. Crall*, 27 Cal.App. 313, 314-15 (1915) (demurrer properly granted where plaintiff failed to identify specific defamatory statements), and quotes *Franchise Realty Interstate Corp. v. San Francisco Local Jt. Executive Bd. Of Culinary Workers,* 542 F.2d 1076, 1082-83 (9th Cir. 1976) (where plaintiffs seek damages for conduct protected by the First Amendment, the danger that the action itself will chill free speech required more specific allegations than otherwise required).

be deemed "substantive" for purposes of the *Erie* doctrine if limited to a particular substantive area. *S.A. Healy Co. v. Milwaukee Metropolitan Sewerage Dist.*, 60 F.3d 305, 310 (7th Cir. 1995). State law must be deemed "substantive" under the *Erie* doctrine, even if there is an otherwise applicable Federal Rule, when the State chooses to use a traditional procedural vehicle to define the scope of substantive rights. *Shady Grove Orthopedic Assocs., P.A. v. Allstate Ins. Co.,* 559 U.S. ___, 130 S.Ct. 1431, 1450 (2010).

California's anti-SLAPP laws have been held to be substantive under the *Erie* doctrine because they do not conflict with Federal Rules. "Plainly, if the anti-SLAPP provisions are not held to apply in federal court, a litigant in bringing meritless SLAPP claims would have significant incentive to shop for a federal forum." *United States ex rel. Newsham*, 190 F.3d at 973; *see also, Vess,* 317 F.3d at 1109. The more specific anti-SLAPP procedure is treated as "substantive" in diversity cases even though there are federal procedures for challenging meritless claims (e.g., Fed. R. Civ. Pro. 12). *Batzel v. Smith,* 333 F.3d 1018, 1025 (9th Cir. 2003); *Condit v. National Enquirer, Inc.,* 248 F.Supp. 2d 945, 952-53 (E.D. Cal. 2002).

Medifast also mistakenly argues that the District Court did not consider all of the allegedly defamatory postings attached as exhibits to its complaint, which it claims contain the exact words of defamation. [AOB, pp. 33-34.] The court

though did consider the "thirty-seven allegedly false statements identified in Medifast's opposition…" [ER 15.] Regardless, pleadings that require a court to make inferences are wholly insufficient. The California Supreme Court has consistently held that courts have no duty to ferret out the essential elements of a cause of action by referring to exhibits. *California Trust Co. v. Gustason,* 15 Cal.2d 268, 272-73 (1940) (*superseded in part by rule in Wennerholm v. Standford University School of Medicine,* 20 Cal.2d 713, 719 (1942)). "Matters of substance must be alleged in direct terms and not by way of recital or reference, much less by exhibits merely attached to the pleadings." *Id.,* citing, *Burkett v. Griffin,* 90 Cal. 532 (1891) (*overruled in part by Gudger v. Manton,* 21 Cal. 2d 537 (1943). This is particularly important where allegations relate to defamation and have the effect of chilling speech.

III. MacDonald Lacked Standing to Bring an Action

Before addressing the substance of Plaintiffs' defamation claims, the District Court determined that MacDonald did not have standing to bring any claims. MacDonald is now deceased and his estate also lacks standing because his personal representatives have not sought to act on behalf of his estate.

A. Minkow's and FitzPatrick's Allegedly Defamatory Statements Were Not "Of and Concerning" MacDonald

The First Amendment establishes broad protection of publications to advance societies' interest in open discussions on matters of public concern.

California's constitutional protections of freedom of expression are broader still. *Blatty v. New York Times Co.,* 42 Cal.3d 1033, 1041 (1986); *Bose Corp. v. Consumers Union of U.S., Inc.,* 466 U.S. 485, 513 (1984). "In defamation actions the First Amendment also requires that the statement on which the claim is based must specifically refer to, or be 'of and concerning' the plaintiff in some way." *Blatty,* 42 Cal.3d at 1042, citing *New York Times Co. v. Sullivan*, 376 U.S. 254, 278-280 (1964). "The 'of and concerning' requirement serves to immunize a kind of statement which, though it can cause hurt to an individual, is deemed too important to the vigor and openness of public discourse in a free society to be discouraged." *Id.* at 1044.

The District Court held that MacDonald failed to meet the two tests for establishing standing that: (1) Defendants' statements could reasonably be understood as referring to him individually, and (2) a reasonable third party understood the statements that way. Citing, *SDV/ACCI, Inc. v. AT&T Corp.,* 522 F.3d 955, 959 (9th Cir. 2008) (internal citation omitted). The court explained that only a few of the dozens of the statements specifically referred to him or associated him with Medifast. Those statements just related to his internet postings promoting Medifast or they repeated his public statements. [ER 7:6-15.]

MacDonald now argues that Defendants' statement about Medifast did specifically refer to MacDonald "by *impliedly* accusing him of covering up

Medifast's fraud and by publically demanding that he answer for Medifast's crimes." [AOB, p. 60, emphasis added.]

According to MacDonald, FitzPatrick implied that MacDonald's comments about Medifast's success were made to cover up Medifast's crimes. He claims FitzPatrick did this by commenting that MacDonald attributed Medifast's success to people wanting to improve their health during a recession, but then saying in the next paragraph that instead FitzPatrick believes TSFL's endless chain is the reason for Medifast's recent success. MacDonald argues this could be understood as claiming he was a part of Medifast's "cover-up of TSFL's criminal structure." [AOB, p. 63.]

FitzPatrick does not accuse MacDonald of a cover-up. He and MacDonald just disagree on what was driving Medifast's unusual growth. No reasonable reader would understand FitzPatrick's opinion that TSFL is an endless chain, as implying that MacDonald was covering up crimes.

MacDonald next argues that he had standing to sue Minkow because Minkow republished FitzPatrick's reports on his website and then targeted MacDonald by posting an open letter to him "asking rhetorical questions regarding Medifast's alleged crimes." [AOB, p.63.]

Minkow's internet postings of FitzPatrick's reports are immunized under the Communications Decency Act of 1996. 47 U.S.C.A. § 230. In addition,

Minkow's open letter to MacDonald and Medifast's independent committee, never refers to any crimes. Instead, it offers a retraction and apology if they could show that any of FitzPatrick's reports were false or misleading. [ER 182.] Among the statements that would be retracted was whether Medifast's recent stock and revenue surge was driven by an endless chain. Nothing attributes crimes to MacDonald. Moreover, Minkow says that he looks forward to hearing from the independent committee. MacDonald is never asked "alone" to answer "the charges that Medifast is engaged in criminal activities" as Plaintiffs contend. [AOB, p.63.]

Finally, MacDonald argues that a reasonable person must have understood Defendants' statements as referring to him because some postings by third parties on an internet message board disparaged him. [AOB 65-66, citing *50 pages* of record.] The District Court dispensed with this argument because none of the postings reference Defendants' statements, with the exception of one that links to a report by Coenen, but it does not reference MacDonald either. [ER 7:16-8:1.]

MacDonald disputes this, arguing that there is a link to Minkow because one post says "Pimp-Daddy-Brad will be in prison along with Madoff." [AOB 66.] However, any connection to an assumed defamatory statement by Minkow is pure speculation. MacDonald contends further that another post by "zeeyourself" suggesting that MacDonald would be "Rooming with Madoff" coupled with another post by "zeeyourself" an hour later citing to Minkow's post about

Medifast's auditor, establish that the first post must be linked to Minkow too. This tenuous connection is double speculation. None of Plaintiffs' evidence establishes that any allegedly defamatory statements specifically refer to, or are of and concerning MacDonald.

B. MacDonald's Estate Lacks Standing to Prosecute His Defamation Claim

MacDonald is now deceased. His personal representatives have not brought a motion to be substituted as a party. A motion to substitute a decedent's personal representative may be filed with the circuit clerk. Fed.R.App.P., 43. "[A]ny party may suggest the death on the record and the court of appeal may then direct appropriate proceedings." *Id.*

IV. Medifast is a Public Figure Required to Prove Malice

In evaluating whether Plaintiffs had established a prima facie claim to avoid their complaint being stricken as a SLAPP suit, the District Court determined that Medifast is not a public figure. As a result, the court applied the wrong evidentiary standard.

"Public officials" may not prevail in an action for libel relating to their official conduct without proof that the allegedly false statement was made with "actual malice." *New York Times Co. v. Sullivan,* 376 U.S. at 279-80. The same rule applies to private plaintiffs who are "public figures." *Curtis Publishing Co. v. Butts,* 388 U.S. 130, 164 (1967).

Two different categories of public figures exist. *Gertz v. Robert Welch, Inc.*, 418 U.S. 323 (1974). The first is the all-purpose public figure (which Defendants do not allege). The second is the "limited purpose" public figure who "voluntarily injects himself or is drawn into a particular public controversy and thereby becomes a public figure for a limited range of issues." *Id.* at 351.

> "There are three elements that must be present in order to characterize a plaintiff as a limited purpose public figure. First, there must be a public controversy, which means the issue was debated publicly and has foreseeable and substantial ramifications for nonparticipants. Second, the plaintiff must have undertaken some voluntary act through which he or she sought to influence resolution of the public issue. And finally, the alleged defamation must be germane to the plaintiff's participation in the controversy." *Ampex Corp. v. Cargle,* 128 Cal.App.4th 1569, 1577 (2005), citing *Copp v. Paxton,* 45 Cal.App.4th 829, 845-846 (1996).

The Supreme Court has not specifically defined the meaning of a public controversy. *Annette F. v. Sharon S.,* 119 Cal.App.4th 1146, 1164 (2004). Nevertheless, California has followed the Court of Appeals for the District of Columbia's definition to mean "a dispute that [ ] has received public attention because its ramifications will be felt by persons who are not direct participants." *Copp,* 45 Cal.App.4th at 845, citing to *Waldbaum v. Fairchild Publications, Inc.,* 627 F.2d 1287, 1296 (D.C. Cir. 1980).

A. A Public Controversy Exists Concerning Medifast and TSFL

A public controversy exists regarding Medifast's treatment for obesity and TSFL's business operations. Medifast aggressively solicits the public's attention

in its efforts to capitalize on America's obesity epidemic and efforts to treat it. *Wolston v. Reader's Digest Ass'n, Inc.*, 443 U.S. 157, 168 (1979). Medifast spends tens of millions of dollars annually promoting its treatment for this "epidemic" including the use of several celebrities under contract. [SER 997.] Medifast markets its products in direct appeals to the obese demographic and to others in the general public wanting to lose weight. [SER 1016-1017.] By implementing mass nation-wide advertising, Medifast tries to influence public opinion regarding the legitimacy of weight-loss products. *Id.* at 168.

The District Court cited *Vegod Corp. v. American Broadcasting Companies, Inc.*, 25 Cal.3d 763 (1979), for the proposition that a person in the business world advertising his wares does not necessarily become part of an existing public controversy; however, Medifast went far beyond advertising its wares. [ER 12-13.] Medifast instigated public debate regarding America's obesity crisis and through its resort to a controversial business model for TSFL. [SER 593-94, 602-03, 608, 614-615, 997.]

The court acknowledged that a public controversy exists concerning TSFL's business model and Medifast's business practices. [ER 11-12.] Medifast knew that the TSFL platform might be interpreted as a "pyramid" or "chain sale" scheme. [SER 1021.] When Medifast issued ongoing press releases about TSFL's thriving platform, it engaged in conduct calculated to draw attention and comment.

B. Medifast Thrusts Itself Into the Public Eye

Courts look for affirmative actions by which entities thrust themselves into the forefront of public awareness when determining public figure status. *Reader's Digest Assn v. Superior Court,* 37 Cal.3d 244, 254-255 (1984). Medifast does that by soliciting public attention and media coverage of its weight-loss products, which it touts as highly successful relying on the aberrant success of TSFL's multi-level marketing. Medifast voluntarily placed itself the public eye through its media blitzes, including promotions and press releases. Through the variety of media channels it uses, Medifast supplies its own means of self-promotion. *Ampex Corp.,* 128 Cal.App.4th at 1578.

California law recognizes that if plaintiff enjoys access to channels of communication regarding a dispute, he or she can become public figures. When a plaintiff had a realistic opportunity to counteract false statements he was found to be a limited public figure. *Moseian v. McClatchy Newspapers,* 233 Cal.App.3d 1685, 1689-1693 (1991) (public controversy was the subject of at least 31 newspaper articles and numerous radio and television news commentaries).

C. Defendants' Statements Were Germane to Medifasts' Controversy

Although not addressed by the District Court, Defendants' allegedly defamatory statements were germane to Medifast's participation in the controversy. *Ampex Corp.,* 128 Cal.App.4th at 1578. Here, Defendants' comments

were based on information provided in Medifast's financial and marketing material, and in misleading statements about its Health Coaches' income. [SER 24, ¶ 12-13, 821, 912.] The statements pertained to the public debate over Medifast's weight-loss products and its business practices. [ER 52-59, SER 652, ¶¶ 9-10, 653, ¶ 15.] This combination of factors makes Medifast is a limited purpose public figure.

V. Minkow and FDI Are Immunized From Liability for Republications

Plaintiffs rely on inapposite authority in arguing that Minkow is accountable for FitzPatrick's endless-chain statements because he republished them on the internet, citing, *Flowers v. Carville,* 310 F.3d 1118, 1128 (9th Cir. 2002) (alleged defamation in books and television interviews), and *Ringler Assoc. v. Maryland Cas. Co.,* 80 Cal.App.4th 1165, 1180 (2000) (insurance bad faith action for denial of coverage in underlying defamation action). Those cases did not involve postings on the internet.

Congress has granted broad immunity to internet users who republish information generated by others. In the Communications Decency Act of 1996 ("CDA"), Congress found it to be the policy of the United States that "[n]o provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider." 47 U.S.C. § 230(c)(1). "No cause of action may be brought and no liability may be

imposed under any State or local law that is inconsistent with this section." 47 U.S.C. §230(e)(3).

In interpreting the CDA, California's Supreme Court stated "[t]he provisions of section 230(c)(1), conferring broad immunity on Internet intermediaries, are themselves a strong demonstration of legislative commitment to the value of maintaining a free market for online expression. *Barrett v. Rosenthal*, 40 Cal.4th 33, 56 (2006). Congress has welcomed the "extraordinary advance in the availability of educational and informational resources" created by the internet as a forum for diverse discourse on politics, education, culture and entertainment. *Id.*, citing §230(a)(1), (3) & (5). The immunity applies regardless of the traditional distinctions between "publishers" and "distributors." *Id.* at 39. The *Barrett* court further held that the term "users" of the internet includes individuals and that no distinction can be drawn between active rather than passive conduct. *Id.* at 40.

This Court has explained that CDA immunity might be lost if an individual becomes a co-developer by materially contributing to the alleged unlawfulness of an internet post. *Fair Housing Council of San Fernando Valley v. Roommates.Com, LLC,* 521 F.3d 1157, 1167-68 (9th Cir. 2010). However, Plaintiffs argue that Minkow's anti-SLAPP motion should not have been granted simply because he republished FitzPatrick's February 2009 report. [AOB, p.36-8.]

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Minkow is immune under the CDA from any claim based on his republishing of FitzPatrick's report.

VI. Medifast Did Not Establish a Probability of Prevailing on Its Libel Per Se Claim

To defeat Defendants' anti-SLAPP motions, Plaintiffs had to show a probability of prevailing on their libel per se claim. Under California law, that means Plaintiffs had to show the existence of (1) a publication that is (2) false, (3) defamatory, (4) unprivileged, and that (5) has a natural tendency to injure or cause special damage. *Taus v. Loftus*, 40 Cal.4th 683, 720 (2007), Civ. Code §§ 45-47.

Libel "is a false and unprivileged publication by writing … which exposes any person to hatred, contempt, ridicule or obloquy, or which … has a tendency to injure him in his occupation." *Id.*, § 45. A statement that is defamatory without the need for explanatory matter such as innuendo or other extrinsic fact constitutes "libel on its face" or libel per se. Plaintiffs have alleged only libel per se.

Because Medifast is a limited public figure, it must prove by clear and convincing evidence that the allegedly defamatory statements were made with knowledge of their falsity or with reckless disregard of the truth or falsity. *New York Times Co. v. Sullivan,* 376 U.S. at 279-80.

A. Minkow's Statements Are Not Provably False

To state a claim for defamation that survives a First Amendment challenge, Medifast must present admissible evidence of a statement of fact that is provably

false. *Milkovich v. Lorain Journal Co.*, 497 U.S. 1, 20 (1990). An appellate court "has an obligation to 'make an independent examination of the whole record' in order to make sure that 'the judgment does not constitute a forbidden intrusion on the field of free expression.'" *Id.,* at 17-18; quoting, *Bose Corp. v. Consumers Union of the United States, Inc.,* 466 U.S. at 499 (internal quotations omitted). Statements in the nature of consumer protection information involve matters of public concern and are protected by the First Amendment. *Carver v. Bonds*, 135 Cal.App.4th 328, 344 (2005), citing *Nazim-Aldine v. City of Oakland*, 47 Cal.App.4th 364, 377 (1996).

Whether a statement makes a provably false assertion of fact is a question of law for the court. *Franklin v. Dynamic Details, Inc.* 116 Cal.App.4th 375, 376 (2004). In resolving this question, California courts apply the totality of the circumstances test, first examining whether the language has a defamatory meaning, and then considering the context in which it was made. *Balzaga v. Fox News Network, LLC,* 173 Cal.App. 4th 1325, 1337-38 (2009). Courts look to the natural and probable effect of a statement on the average reader's mind in determining whether it is an actionable false assertion of fact or a protected opinion. *Carver,* 135 Cal.App.4th at 346-47, citing *Baker v. Los Angeles Herald Examiner,* 42 Cal.3d 254, 260 (1986).

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Medifast cannot meet its burden of showing that any of Minkow's statements are provably false assertions of facts, which on their face accuse Medifast of a crime. According to Medifast, Minkow accused it of specific illegal acts: running a Ponzi scheme, a pyramid scheme, and an endless chain. [AOB, p.40.] This is similar to Medifast's earlier argument, which the District Court rejected, that Minkow had accused Medifast of running a Madoff-like Ponzi scheme. [ER 19.]

Medifast's arguments still are fatally flawed as the District Court explained. "Defendants' comments cannot reasonably be understood as implying the provably false assertion of fact Medifast claims they imply, namely that Medifast is running a Ponzi scheme." [ER 19:18-23.] Although Medifast has expanded its arguments to include a "pyramid scheme" and an "endless chain," again there are no provably false assertions.

Medifast faces an insurmountable obstacle because it did not allege the words constituting the defamation. As the District Court observed, Medifast instead characterized Minkow's statements for maximum shock value. Because Medifast cannot identify statements that on their face accuse Medifast of a crime, it now argues that an opinion is defamatory if it can reasonably be understood as either declaring or implying facts capable of being proved false, citing *Standing Committee on Discipline v. Yagman,* 55 F.3d 1430, 1438 (9th Cir. 1995). *Yagman,*

however, was a disciplinary proceeding against an attorney who criticized a judge and did not involve a claim of libel per se, which must be defamatory without explanatory matter.

1. The Madoff Comparisons Are Not Defamatory

In an effort to remedy its pleading defects, Medifast quotes part of an exhibit to its complaint, which it again mischaracterizes for maximum impact. [AOB 43, and ER 88.] Medifast entitles this a comparison between Medifast and "Madoff's massive Ponzi scheme" but no such words are found in the exhibit. Instead, the document is entitled "Points of Similarity Between Madoff and Medifast" based on excerpts of the letters to the SEC and FTC "arguing Ponzi's and Endless Chain Pyramid Schemes are very much alike." [ER 88.]

Not only is Medifast's argument an improper attempt to use an exhibit to provide missing elements of the claim, but the exhibit simply does not accuse Medifast of a crime. At best, Defendants used Madoff "as a contemporary cautionary tale" as the court concluded. [ER 20:1-6.] See, *Makaeff v. Trump Univ., LLC*, 2010 WL 3341638, at *3 (S.D. Cal. Aug. 23, 2010); citing *Carver,* 135 Cal.App.4th at 344; *Wilbanks v. Wolk*, 121 Cal.App.4th 883 (2004) (website statements were protected where consumer information provided).

The exhibit Medifast relies on states that Madoff transferred money to new investors to pay earlier ones. It does not say that Medifast did this, but instead that

the company pushes responsibility of recruiting new people into the scheme on their coaches, with funds from the later coaches paying returns to the earlier ones. [ER 88.] This is not libelous per se and Medifast fails to even identify an allegedly false statement.

Medifast next calls defamatory Minkow's statement that "in Medifast and other MLMs … [c]omplaints about the nature of the MLM industry's false income promises and endless chain scheme go unheeded despite … evidence of fraud." [AOB 44.] The statement, however, only refers to complaints and evidence, and again Medifast does not identify a single false statement of fact.

2. The Endless Chain Comparisons Are Not Defamatory

Medifast refers to the same exhibit to its complaint, this time stating that Minkow's description of TSFL as "a pyramid scheme – another type of criminal enterprise – is libel per se." The document, however, never uses the term TSFL and does not say anywhere that it is "a pyramid scheme – another type of criminal enterprise." (ER 88.)[17] Again, Medifast mischaracterizes the document and is improperly using an exhibit to provide missing allegations. The statement that Medifast identifies actually invites web users to "click here" for excerpts of letters to the SEC and FTC "arguing" that Ponzis and endless chain schemes "are very much alike." That is opinion and, even if a statement of fact, is not libel per se.

[17] Medifast cites ER 1110, and not the same document that is Exhibit 4 to its complaint [ER 88].

To bolster its argument, Medifast states that "[t]his Court has adopted the Federal Trade Comission's test for determining what constitutes a pyramid scheme," citing *Webster v. Omnitrition International, Inc.,* 79 F.3d 776 (9th Cir. 1999). This case though does not involve federal claims against Medifast for operating a pyramid scheme as in *Webster*. It involves Medifast's claims against Defendants for defamation concerning the existence of an endless chain under California law.

Medifast wants to use the definition of a pyramid based on certain FTC related cases because it is narrower and requires that participants receive "in return for recruiting other participants … rewards which are unrelated to the sale of the product to the ultimate user." *Webster,* 79 F.3d. at 781. California's "endless chain" law is broader and requires that the participant pay "valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme…" and does not depend on the existence of rewards being unrelated to the product sales. Penal Code, § 327. The FTC definition is not relevant. Regardless, Medifast's use of bonuses and commissions on internal sales, among other things, provides the additional element for a pyramid under the FTC definition as well.

Minkow's reference to TSFL's business model as an endless chain and comparing it to Madoff's Ponzi scheme is not libelous per se. [AOB 46-49.] He

was stating his opinion and he did not accuse Medifast of a crime. Medifast does not identify any facts that are false and is relying on the wrong law. Once more, Medifast tries to use an exhibit to remedy pleading defects. [ER 83.]

Medifast again fails to meet its burden arguing that Minkow's website posts are defamatory because they attribute Medifast's record sales to a disguised pyramid scheme. [OAB 46-48.] Minkow was stating his opinion and identified the underlying facts. Indeed, Medifast admits that it joined the discussion to offer its position. Minkow even asked Medifast to identify any falsehoods, which it did not do. None of this is libel on its face, and once again Medifast is relying improperly on exhibits to its complaint to address pleading defects.

Unable to identify any libel per se, Medifast argues that the "assumed or expressly stated facts" upon which Minkow bases his "opinion" are that "Medifast concentrates on recruiting coaches rather than selling products …" [AOB 48.] Minkow, however, draws no such distinction. Even if he did, the assumed facts do not accuse Medifast of a crime, certainly not without explanatory matter, as the District Court held. [ER 21:15-17.] Medifast has not identified any provably false statements of facts that a reasonable reader would find defamatory.

3. The District Court Applied the Correct Law

Medifast challenges the District Court's reliance on California law, this time for the proposition that "recovery for defamation may be had only for false

statements of fact. Statements of opinion are not actionable." [ER 13-14, quoting, *Info. Control Corp. v. Genesis One Computer Corp.,* 611 F.2d 781, 783 (9th Cir. 1980).] Medifast states that the court relied on pre-1990 law, which "is not an accurate reflection of defamation law." [AOB 54, citing *Milkovich,* 497 U.S. at 21.]

The District Court's statement of the law is accurate. It cited recent cases in explaining that "[t]he key is not parsing whether a published statement is fact or opinion, but 'whether a reasonable fact finder could conclude the published statement declares or implies a provably false assertion of fact.'" [ER 14, citing *Overstock.com, Inc. v. Gradient Analytics, Inc.,* 151 Cal.App.4th 688, 700-701 (2007), quoting *Franklin v. Dynamic Details, Inc.,* 116 Cal.App.4th at 384.]

Medifast reads too much into *Milkovich.* That case did not reject a fundamental principal of First Amendment law that opinions are not actionable in defamation. Rather, the U.S. Supreme Court explained that "*an additional separate* constitution privilege for 'opinion'" is not required to ensure freedom of expression. *Milkovich,* 497 U.S. at 21 (emphasis added). The court explained in a subsequent case that "we refused 'to create a wholesale **defamation** exemption for anything that might be labeled '**opinion**'" because expressions of opinions might imply an assertion of objective fact." *Masson v. New Yorker Magazine, Inc.,* 501 U.S. 496, 516 (1991) (emphasis in text).

Since then, this Court too has explained that "[t]he First Amendment places limits on the types of speech that may give rise to a defamation cause of action under state law. *Gilbrook v. City of Westminster,* 177 F.3d 839, 861 (9th Cir. 1999), citing *Milkovich,* 497 U.S. at 14-21. "Such protection extends to statements of opinions, addressing matters of public concern that do not 'contain a provably false factual connotation' (citations omitted) and to statements that cannot 'reasonably [be] interpreted as stating actual facts.'" *Id.* (citation and internal quotations omitted). The law has not changed.

Medifast's obstacle is not the law that was applied, but rather the defective pleadings that it tries to remedy by resorting to exhibits, which contain opinions that a reasonable reader would not understand to include provably false statements. Medifast cannot establish a prima facie claim of libel per se against Minkow, much less by clear and convincing proof of malice.

B. Statements Made by FitzPatrick Are Not Provably False

As with the libel per se claim against Minkow, Medifast must make a prima facie showing that FitzPatrick's statements are provably false to survive his anti-SLAPP motion. Additional analysis is required, however, because FitzPatrick did opine in his report that Medifast's multi-level marketing scheme for TSFL meets the definition of an 'endless chain' outlawed in California under Penal Code section 327. [ER 54.]

The District Court found FitzPatrick's statement about TSFL being an endless chain to be the only one a reasonable fact finder could conclude was a provably false statement of fact. The court further found that Medifast made a prima facie showing that FitzPatrick's statement was false. [ER 15:12-16:24.] In reaching its conclusion, the court relied on Bell's misleading declaration.

Medifast argues that the FTC's "pyramid" definition applies, and not California's "endless chain" definition. Consequently, the court focused on the wrong criteria. As a result, the court found that under TSFL's compensation plan, "no compensation of any kind is paid *merely* for 'recruiting' or sponsoring another coach" that "bonuses are not paid for *simply* 'introducing one or more additional persons into participation'" and that "the *vast majority* of orders of Medifast products … are placed by clients (as opposed to health coaches) who are not participants in the scheme." [ER 16, quoting Bell Decl. ¶¶ 38, 59-67, 35 & 56, emphasis added.]

California's endless chain law, however, does not balance whether *some* of a participant's compensation comes from sales of products to non-participants, or whether the compensation is not for *merely* recruiting or *simply* for introducing additional participants. By definition, the issue is whether the participant gets *any* compensation for introducing additional participants. Penal Code section 327 provides:

> [A]n "endless chain" means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme.

There is no exemption for participants such as TSFL's who receive compensation for introducing additional participants, but nevertheless receive part of their consideration for product sales to non-participants. Indeed, the statute assumes there will be product distribution, but the scheme becomes an endless chain when the participant receives compensation for introducing additional participants. Incidental sales to non-participants does not change the analysis.

The case cited by the District Court supports Defendants, not Medifast. See, *People v. Bestline Prods., Inc.,* 61 Cal.App.3d 879, 914 (1976). The *Bestline* case explains that a sales plan *does not come within the definition* of an endless chain under section 327 when "the compensation for recruitment *is limited* to 'payment based upon sales made to persons who are not participants and who are not purchasing in order to participate in the scheme." *Id.* TSFL's scheme is not limited this way. Its participants also receive compensation from sales to lower level participants (Health Coaches) already within the scheme and from new participants recruited into the scheme, both in the form of commissions and as bonuses.

FitzPatrick's interpretation of California's endless chain statute is further supported by *Bounds v. Figurettes, Inc.,* 135 Cal.App.3d 1 (1982), which analyzed the *Bestline* case. Both *Bestline* and *Figurettes* involved multilevel sales schemes, and the court rejected *Figurettes'* attempt to focus on the importance of the retail sales to non-participants as a way to distinguish itself from the illegal pyramid in *Bestline*. *Id.* at 18-19. Despite Figurettes' extensive evidence of retail sales volume and training in retail selling techniques, the court held that "retail sales do not legalize the pyramid marketing scheme which violates Penal Code section 327." *Id.*

Medifast again tries to divert this Court arguing that the "pyramid" definition applies, based on some cases with FTC claims. As discussed above, the FTC approach is more narrow and requires that participants receive, in return for recruiting participants, "rewards which are unrelated to the sale of the product to the ultimate user." *Webster,* 79 F.3d at 781. That definition does not apply, but if it did, TSFL would still qualify as a "pyramid", because Medifast pays rewards that are unrelated to the sale of its products to ultimate users; that is, persons who are not participants in the scheme. FitzPatrick correctly analyzed TSFL's business model as meeting California's endless chain definition. He identified the recession-defying spike in TSFL's sales as indicia of a possible pyramid, particularly when compared to others in the industry. He learned that TSFL has

ten levels of Health Coaches. New coaches receive the chance to sell Medifast products by paying an entry fee which allows them to collect commissions on sales to clients or to new recruits. That satisfies California's definition of an endless chain. The coaches also get compensation as bonuses and as additional commissions on the sales to down-line coaches and from sales to the new coaches they recruit. That meets both California's definition and the FTC case-definition of a pyramid.

FitzPatrick's opinion was based on fully disclosed facts that are substantially accurate. "A statement of opinion based on fully disclosed facts can be punishable only if the stated facts are themselves false and demeaning." *Yagman,* 55 F.3d at 1439, citing *Lewis v. Time, Inc.,* 710 F.2d 549, 555-56 (9th Cir.1983) (*implied overruling recognized in UNELCO Corp. v. Rooney,* 912 F.2d 1049 (9th Cir. 1996); Restatement (Second) of Torts § 566, Comment c (1977). The straightforward rationale for this is that readers understand they are getting the author's interpretation and are free to accept or reject it based on their independent evaluation. *Id.*

Medifast quibbles with the accuracy of some of FitzPatrick's numbers and calculations, but the essence of his comments is correct. Given Medifast's incomplete disclosures in its public materials, certain inaccuracies were inevitable. Regardless, under California law a statement is not "false" for purposes of a

defamation suit if the "substance, the gist, the sting" of statement is justified. *Vogel v. Felice*, 127 Cal.App.4th 1006, 1021 (2005), citing *Masson,* 501 U.S. at 516-17. An inaccurate statement is substantially true if it has no difference in effect on a reasonable reader than the pleaded truth would have had. *Id.*

After FitzPatrick's report, Medifast was required to restate its 2009 10k Report to the SEC, which included more complete information on TSFL. Medifast also provided for the first time an Official Income Disclosure Statement revealing the gross disparity in income through the ascending levels of its Health Coaches. FitzPatrick provided a valuable public service in offering his opinion to an unsuspecting public that TSFL is an endless chain. As the *Bestline* case quoted:

> The very scheme itself bears evidence upon its face that it is a fraud and a snare and yet so cunningly devised that, in the hands of a sharp, shrewd, and designing man, hundreds of the unwary have been defrauded; and the courts should set their seal of condemnation upon it …

Bestline Products, Inc., 61 Cal.App.3d at 912 (citation omitted).

Several of Medifast's existing or former executives are sophisticated veterans of multilevel marketing at such places as Amway/Quixtar and BurnLounge, which have been successfully prosecuted. Some are Presidential Health Coaches who in 2009 received on average *over $53,000 per month.*

Medifast has succeeded in chilling speech about its TSFL multilevel marketing scheme. FitzPatrick has been silenced to the detriment of consumers.

Still, there is no such thing as a false idea under the First Amendment. "However pernicious an opinion may seem, we depend for its correction not on the conscience of judges for juries, but on the competition of ideas." *Milkovich,* 497 U.S. at 17-18, quoting *Letter Carriers v. Austin,* 418 U.S. 264, 284-286 (1974). FitzPatrick's opinion was right about TSFL being an endless chain, and his anti-SLAPP motion to strike should have been granted in that regard too.

VII. FitzPatrick Rebutted Medifast's Attempt to Prove Defendants Statements Were False

FitzPatrick replied to Bell's evidence with a declaration explaining that his opinion had not changed that TSFL is an endless chain. [SER 740-745.] It is not surprising then, that the District Court said FitzPatrick did not present evidence to rebut Bell's declaration other than restating his report. [ER 16.] The court's comment can be understood considering Bell's declaration assumes a different legal analysis than FitzPatrick's. The court accepted Medifast's analysis, which assumed an FTC case interpretation of a pyramid, and not FitzPatrick's analysis, which applied California's law.

FitzPatrick shows that, although cleverly presented, Bell's declaration admits facts confirming the elements of an endless chain, and that when other unstated facts are added, TSFL's endless chain is exposed. Following FitzPatrick's report, Medifast was required to add disclosures about TSFL's multi-level marketing. [SER 731, ¶8.] In its restated 10k Report, Medifast concedes for the

first time that it markets "business opportunities" as well as diet products. [SER 734, ¶18.] Medifast also warned it stockholders that TSFL posed a risk for being interpreted under certain laws as being a "pyramid" or "endless chain." [SER 736, ¶25.] The new disclosures, however, did not change the fundamental factors considered in FitzPatrick's original report. [SER 737, ¶30.]

A. FitzPatrick Showed That Bell's Explanation of TSFL's Pay Plan Confirms the Endless Chain

Bell states that Medifast's retail sales are at a percentage where the plan cannot be considered a pyramid scheme. [ER 1009, ¶35.] However, the law in California does not set percentages. [SER 738, ¶34.]

FitzPatrick reasserts in rebuttal that the fundamental elements of an endless chain inherent in TSFL's scheme are not invalidated by Bell's selective statistics. While Bell contends that Medifast's focus is all that matters, FitzPatrick counters that the elements of an endless chain have been revealed. TSFL distributes its dietary products in a scheme whereby participants pay for the chance to receive compensation for introducing other participants.

Bell admits that consumers can become Health Coaches by paying consideration, currently $199, and that the coaches also pay a renewal fee of $30 every six months. [ER 1013-14, ¶¶49-50 & 53.] That is valuable consideration under California law. Medifast's authorized Health Coaches then receive the right to obtain commissions from their sales, including sales to new coaches they recruit.

[ER 1006, ¶¶ 24-25.] That is compensation for introducing new participants under California law.

Although the rudimentary facts that Bell admits alone reveal an endless chain, the scheme is more elaborate. Health Coaches can become Business Coaches by acquiring more clients and health coaches. In doing so, the Business Coach gets a percent of the revenue generated by the Health Coach, which might be a smaller percent, "but it is on a larger volume." [ER 1006-1007, ¶¶ 24-26 &30.] This satisfies California's alternative definition of an endless chain because "it is a chance to receive compensation when a person introduced by the participant introduces a new participant."

Bell further acknowledges that TSFL uses a bonus structure. Among them are: an "acquisition bonus" for obtaining five retail customers, which would include those that become coaches; a "client-assist bonus" if a coach sponsors another coach who obtains five new retail clients; and "growth bonuses" of various types when senior coaches "grow their businesses" by either "volume" or "structure" which means recruiting by downline coaches. [CR 1016-17, ¶¶ 59-63.] FitzPatrick prepared a chart to show how the bonuses aggregate to benefit the highest levels of Health Coaches. [SER 339.] The bonus structure also satisfies the definition of an endless chain.

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FitzPatrick explained in rebuttal that although TSFL's rewards are made through a complex formula of commissions and bonuses, Medifast does not deny that it includes significant rewards for expanding the base of participants who pay to join. This underlying fact remains despite Bell's parsed statistical data. [SER 743, ¶¶ 50-51.]

B. FitzPatrick Rebutted Bell's Half-Truths With Additional Facts Exposing the Endless Chain

Medifast's failure to make a prima facie showing is more apparent when FitzPatrick added missing facts to reveal TSFL's dependence on recruiting to replace the dwindling ranks of entry-level Health Coaches. The attrition rate of participants is not a specific factor considered by California law, but it does reflect a business structure dependent on an endless chain.

Bell states that from May 2009 through April 2010, TSFL enrolled 6,356 new coaches, and that as of May/June 2010 it had about 8,000 coaches. He adds that during the time period TSFL also gained 102,505 new ordering clients. [ER 1008-09, ¶¶33-34.] This by itself establishes nothing because Bell does not state how new "clients" became coaches. Equally important, he does not disclose the attrition rate of coaches.

In rebuttal, FitzPatrick explained that Bell omitted the critical starting-point data. Bell states that 6,356 new coaches were added resulting in a total of 8,000 coaches. But, he does not say how many coaches existed at the beginning of the

time period. FitzPatrick found that information in Medifast's report to the SEC where Medifast stated it had 4,000 active coaches enrolled as of March 31, 2009. That meant 2,356 coaches, or about 60%, had quit (4,000 at the start + 6,356 new = 10,356 – 8000 at the end = 2,356 attrition). [SER 746, ¶¶ 63-64.]

This churn rate of Health Coaches is an earmark of an endless chain that would have to expand in ever growing numbers if Medifast were to continue its reported revenue growth rate of 94%. TSFL is dependent on recruiting coaches in a market that is limited and diminishing. FitzPatrick not only rebutted any prima facie showing that Medifast might have made, but he also showed that Bell concealed information reflecting the opposite of what he claims to have proven.

VIII. Medifast Has Waived its Appeal of the Conspiracy, Market Manipulation and Unfair Business Practice Claims

Medifast has not provided any argument to support a reversal of the order striking the claims for conspiracy, violation of Corporation Code section 25400, and violation of Business and Professions Code section 17200. Should Plaintiffs contend that they have preserved their appeal as to those claims, Defendants provide the following argument:

The District Court held that to establish a claim for conspiracy, a plaintiff must show that "the defendant and at least one other person concurred in the tortious scheme with knowledge of its unlawful purpose." Citing, *Wilcox v. Superior Court,* 27 Cal.App.4th 809, 827-28 (1994). "Medifast present[ed] no

evidence of an agreement between FitzPatrick and any other person to injure Medifast in its reputation." Accepting as true Medifast's allegation that Minkow's purpose was to depress Medifast's stock value, neither FitzPatrick nor Coenen ever traded in Medifast stock, and had other purposes in investigating Medifast. [ER 22:10-15.]

As to Plaintiffs' claim for market manipulation, the court explained that section 25400 makes it unlawful to make false statements or engage in fraudulent transactions affecting a securities' market if done to induce a purchase or sale, or raise or depress the securities' price. [ER 22:27-23:2.] Citing, *Diamond Multimedia Sys., Inc. v. Superior Court,* 19 Cal.4th 1036, 1041 (1999). Plaintiffs, however, "[did] not allege that they are purchasers or sellers of securities harmed by Defendants' alleged market manipulation." [ER 23:6-7.] Plaintiffs offered no evidence that they purchased or sold securities during the relevant time period. *Id.*

Finally, the court dispensed with Plaintiffs' unfair business practices claim because it is derivative. The other claims had been stricken except the libel per se claim against FitzPatrick and, and as to him, the court held that there was no evidence that any of the other Defendants collaborated with him in developing his report. [ER 25:2-4.] Regardless, "Plaintiffs failed to establish that FitzPatrick's report was likely to deceive a reasonable consumer." [ER 25:8-9, citing *Overstock.com*, 151 Cal.App.4th at 714.]

Plaintiffs' brief lacks argument containing "appellant's contentions and the reasons for them, with citations to the authorities and parts of the record on which the appellant relies …" Fed.R.App.P. 28(a)(9)(A). By not discussing in the body of their brief the District Court order striking the claims other than libel per se, Medifast has waived the appeal of those claims. *Martinez-Serano v. I.N.S.*, 94 F.3d 1256, 1259 (9th Cir. 1996).

CONCLUSION

For the foregoing reasons, Minkow and FDI respectfully request that the District Court's order granting their anti-SLAPP motion be affirmed; and, FitzPatrick respectfully requests that order granting in part and denying part his anti-SLAPP motion be affirmed as to the part granted and reversed as to the part denied.

Respectfully submitted,

Dated: May 11, 2012

MULVANEY BARRY BEATTY LINN & MAYERS LLP

By: *s/ John H. Stephens*
John H. Stephens
Patrick L. Prindle
Stacy H. Rubin
Attorneys for *Defendants – Appellees* Barry Minkow and Fraud Discovery Institute, Inc., and *Defendant – Appellee – Cross-Appellant* Robert FitzPatrick

RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, Defendants-Appellees Barry Minkow and Fraud Discovery Institute, Inc., and Defendant-Appellee-Cross-Appellant Robert FitzPatrick state that they are not aware of any other pending related cases.

Dated: May 11, 2012

MULVANEY BARRY BEATTY LINN & MAYERS LLP

By: *s/ John H. Stephens*
John H. Stephens
Patrick L. Prindle
Stacy H. Rubin
Attorneys for *Defendants – Appellees* Barry Minkow and Fraud Discovery Institute, Inc., and *Defendant – Appellee – Cross-Appellant* Robert FitzPatrick

CERTIFICATE OF COMPLIANCE

Pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C) and Ninth Circuit Rule 32-1, I certify that this Appellees' Principal and Response Brief is proportionately spaced, has a typeface of 14 points or more, and contains 16,473 words excluding those parts exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

Dated: May 11, 2012

MULVANEY BARRY BEATTY LINN & MAYERS LLP

By: *s/ John H. Stephens*
John H. Stephens
Patrick L. Prindle
Stacy H. Rubin
Attorneys *Defendants – Appellees* Barry Minkow and Fraud Discovery Institute, Inc., and *Defendant – Appellee – Cross-Appellant* Robert FitzPatrick

9th Circuit Case Number(s) 11-55687, 11-55699

NOTE: To secure your input, you should print the filled-in form to PDF (File > Print > *PDF Printer/Creator*).

****

CERTIFICATE OF SERVICE
When All Case Participants are Registered for the Appellate CM/ECF System

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on (date) 5/11/2012 .

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

Signature (use "s/" format) s/ John H. Stephens

****

CERTIFICATE OF SERVICE
When Not All Case Participants are Registered for the Appellate CM/ECF System

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on (date) .

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

I further certify that some of the participants in the case are not registered CM/ECF users. I have mailed the foregoing document by First-Class Mail, postage prepaid, or have dispatched it to a third party commercial carrier for delivery within 3 calendar days to the following non-CM/ECF participants:

Signature (use "s/" format)

11-55687, 11-55699

IN THE

United States Court Of Appeals

FOR THE NINTH CIRCUIT

MEDIFAST, INC., a Delaware corporation,

Plaintiff-Appellant-Cross-Appellee,

BRADLEY MACDONALD, an individual,

Plaintiff-Appellant,

-v.-

BARRY MINKOW, an individual; FRAUD DISCOVERY INSTITUTE, INC., a California corporation; TRACY COENEN, an individual; and SEQUENCE, INC., a Wisconsin service corporation,

Defendants-Appellees,

ROBERT L. FITZPATRICK, an individual,

Defendant-Appellee-Cross-Appellant

On Appeal from the United States District Court
for the Southern District of California
D.C. No. 3:10-cv-00382-JLS-BGS

MOTION AND REQUEST FOR JUDICIAL NOTICE IN SUPPORT OF APPELLEES' PRINCIPAL AND RESPONSE BRIEF

MULVANEY BARRY BEATTY LINN & MAYERS LLP
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Attorneys for Defendants-Appellees, Barry Minkow and Fraud Discovery Institute, Inc., and Defendant-Appellee-Cross-Appellant, Robert L. Fitzpatrick

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TABLE OF AUTHORITIES

CASES

RULES

In accordance with Federal Rules of Evidence, Rule 201, Defendants/Appellees Barry Minkow ("Minkow") and Fraud Discovery Institute, Inc. ("FDI") (sometimes together "Minkow"), and Defendant/Appellee/Cross-Appellant Robert FitzPatrick ("FitzPatrick") respectfully request that this Court take judicial notice of the existence and content of the following documents:

Exhibit 1: Steve Kilar, *McDevitt Out as CEO of Medifast* (Feb. 2, 2012) <http:www.baltimoresun.com/business/bs-bz-mcdevitt-leaves-medifast-20120202,0,503707.story> [as of April 25, 2012].

Exhibit 2: Yahoo! Finance Medifast, Inc. Common Stock Charts from 1994 through 2012 and 2007 through 2012 <http://finance.yahoo.com/echarts?s=MED+Interactive> [as of May 7, 2012].

Exhibit 3: Yahoo! Finance Medifast, Inc. Insider Transactions Reported - Last Two Years <http://finance.yahoo.com/q/it?s=MED+Insider+Transactions> [as of May 8, 2012].

Exhibit 4: Plea Agreement between the United States of America and Barry Minkow filed in the United States District Court, Southern District of

Pursuant to Rule 201 of the Federal Rules of Evidence, the court should take judicial notice of facts "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201. Rule 201(b)(2) requires two conditions: (1) that the fact in question is "capable of accurate and ready determination" and (2) that the source used to determine its accuracy be beyond reasonable question.

Here, both conditions are met. The documents are appropriate for judicial notice as they are records capable of being readily ascertained. *Lichoulas v. City of Lowell,* 555 F.3d 10, 13 (1st Cir. 2009) (rejecting argument that the trial court was limited to accept all pleaded allegations, as it was held proper to judicially notice their falsity; *LaGrasta v. First Union Securities, Inc.,* 358 F.3d 840, 842 (11th Cir. 2004) (applying Federal Rules of Evidence, Rule 201 in taking judicial notice of stock prices on motion to dismiss securities fraud class action).

Moreover, the Court may take judicial notice of proceedings and filings that are matters of record in other courts, including those occurring during the pendency of the federal appeal. *United States v. Borneo, Inc.,* 971 F.2d 244, 248 (9th Cir. 1992) (taking judicial notice of state court proceedings); *Shaw v. Hahn,* 56 F.3d 128, 1129, fn. 1 (9th Cir. 1995) (taking judicial notice of order from another court).

Based on the foregoing reasons, Defendants/Appellees Barry Minkow and Fraud Discovery Institute, Inc. and Defendant/Appellee/Cross-Appellant Robert FitzPatrick respectfully request that the Court take judicial notice of the existence and content of the attached document.

Dated: May 11, 2012

MULVANEY BARRY BEATTY LINN & MAYERS LLP

By: */s/ John H. Stephens*
John H. Stephens
Patrick L. Prindle
Stacy H. Rubin
Attorneys *Defendants – Appellees* Barry Minkow and Fraud Discovery Institute, Inc., and *Defendant – Appellee – Cross-Appellant* Robert FitzPatrick

EXHIBIT – 1

www.baltimoresun.com/business/bs-bz-mcdevitt-leaves-medifast-20120202,0,503707.story

baltimoresun.com

McDevitt out as CEO of Medifast

'Mutually agreed' exit; board chairman to take over

By Steve Kilar, The Baltimore Sun

9:39 PM EST, February 2, 2012

Medifast Inc., an Owings Mills-based maker and provider of weight-loss programs, said Thursday it would replace its chief executive officer next week with the company's board chairman.

The employment agreement for Michael S. McDevitt, the current CEO, expires Wednesday, and he and the board mutually agreed not to renew his contract, the company said. McDevitt led the company during a period of growth over the past five years; he had joined Medifast in 2002.

McDevitt will be replaced by Michael C. MacDonald, a board member since 1998 and executive chairman since November. MacDonald most recently was an executive vice president at Office Max Inc., where he led a $3.6 billion business unit, Medifast said. MacDonald will take over as CEO on Wednesday.

Although the stock has slumped this year, "the story of the CEO changeover is to consolidate control within the MacDonald family," said Gary Albanese, a senior equity analyst at Auriga USA who specializes in the beverage and weight-loss industries.

On Nov. 3, Bradley T. MacDonald — Michael C. MacDonald's older brother and the father of Medifast President Margaret MacDonald-Sheetz — resigned as executive chairman of the company's board because of health issues. Until McDevitt took over as CEO, Bradley Macdonald had been both chairman and CEO from 1998 to 2007.

In November, Michael MacDonald stepped into his brother's position, and now the younger MacDonald takes the reins as CEO as well.

The CEO change should not trouble investors much, Albanese said, because MacDonald has a long history with the company. He has been on the board since 1998.

An added reason for optimism, Albanese said, is that Medifast's 2012 plan is well established. The company is moving ahead with building 30 to 35 new weight-control centers this year, and training

initiatives for weight-loss coaches are largely complete, allowing many of the company's employees to go back to increasing sales, he said.

Alecia Pulman, a spokeswoman for Medifast, said the end of McDevitt's contract offered "a natural transition for Mike MacDonald to take over the role of CEO for the next stage of growth."

A phone call to McDevitt was not returned Thursday evening.

In 2010, booming sales of weight-loss products led Forbes magazine to put Medifast on top of its list of the best small public U.S. companies. That year, McDevitt's pay was $1,655,550, up 34 percent from the year before. In 2009, he made $1,239,800. There were 19 Baltimore-area companies that paid their heads more than $1 million in 2010.

Early last year, Medifast's stock took a beating after the company delayed its fourth-quarter 2010 earnings report to remedy accounting issues, a move that then brought on legal problems. Although the company showed significant growth after the report was finally released, the earnings were not as good as investors expected and the company downgraded its first-quarter outlook, sending stocks further south.

Medifast has been in the diet industry for more than 30 years and employs 500 people in Maryland. Along with its headquarters, the company's food production facility — where shakes, meal bars and other diet foods are made — is also in Owings Mills. A distribution facility is on the Eastern Shore.

In 2010, the company's revenue was $257 million, up 52 percent from 2009. Competitors Weight Watchers International Inc. and NutriSystem Inc., had $1.5 billion and $510 million in revenue, respectively.

According to the company's most recent quarterly U.S. Securities and Exchange Commission filing, in the first nine months of 2011 Medifast revenue was almost $229 million, on track to surpass the prior year's revenue — though the fourth-quarter numbers will not be released for several weeks.

Profits for the first three quarters of 2011 were just over $17 million. Medifast's profit increased in 2010 by 72 percent, to $19.6 million, from $11.4 million a year earlier.

On Thursday, Medifast's stock opened at $16.38 and closed at $16.10. Its 52-week high was $27.82; the low was $12.97.

Gus G. Sentementes contributed to this article.

steve.kilar@baltsun.com

twitter.com/stevekilar

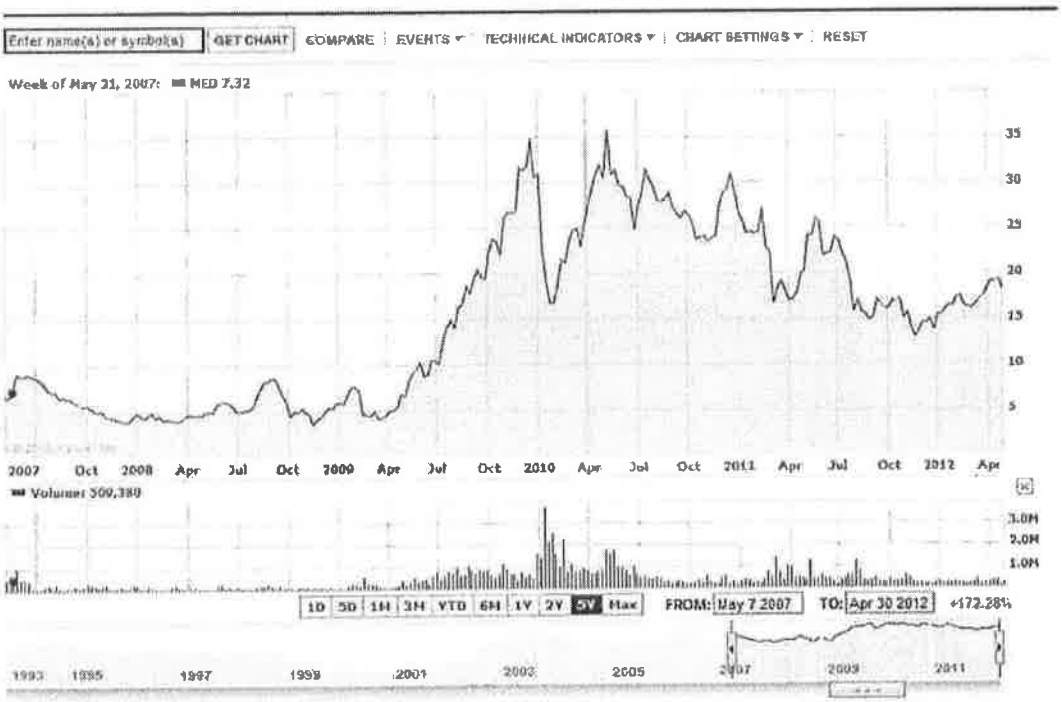
EXHIBIT – 2

MEDIFAST INC Common Stock Stock Chart | MED Interactive Chart - Yahoo! Finance

Medifast Inc. (MED) - NYSE

Add to Portfolio Like 9

18.38 ↑0.11 (0.60%) 2:22PM EDT - Nasdaq Real Time Price



Basic Chart | Full Screen | Print | Share | Send Feedback

Quotes delayed, except where indicated otherwise Currency in USD

Headlines

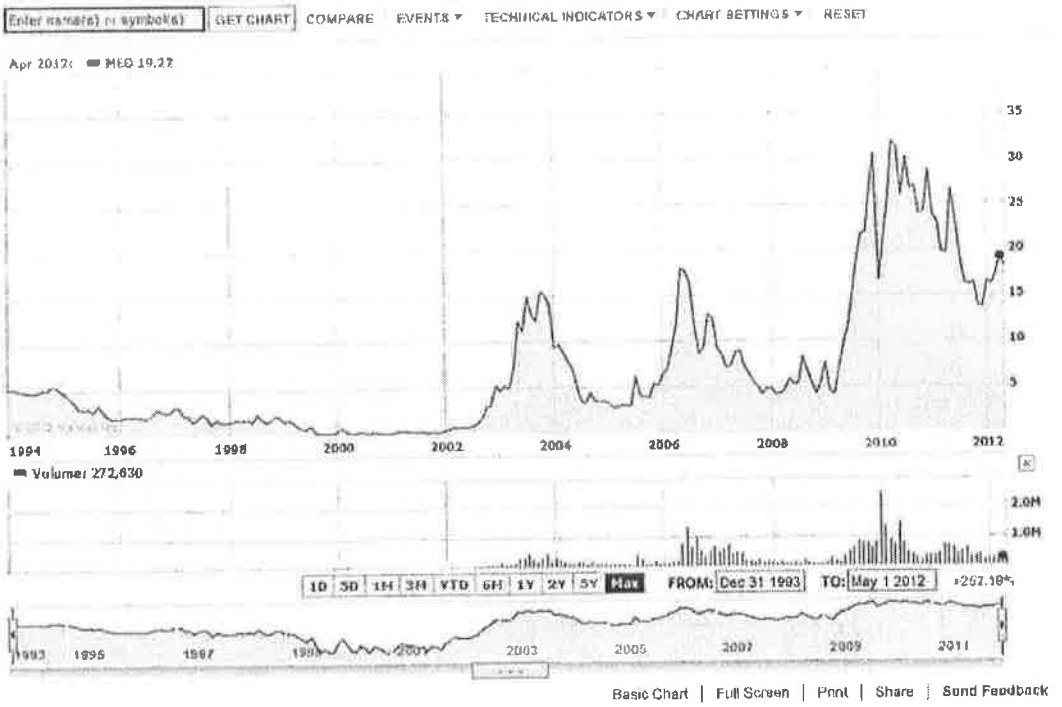
- Shares Plunge as Weight Watchers Slims Down at Wall St. Cheat Sheet Thu, May 3
- Medifast, Inc. First Quarter Earnings Sneak Peak at Wall St. Cheat Sheet Thu, May 3
- 6 Highly Undervalued Stocks With Bullish Short Trends at Seeking Alpha Sun, Apr 29

MEDIFAST INC Common Stock Stock Chart | MED Interactive Chart - Yahoo! Finance

Medifast Inc. (MED) - NYSE

Add to Portfolio Like 9

18.38 ↑0.11 (0.60%) 2:22PM EDT - Nasdaq Real Time Price



Basic Chart | Full Screen | Print | Share | Send Feedback

Medifast Inc. (MED) - NYSE

Prev Close:	18.27	Day's Range:	17.97 - 18.60
Open:	18.18	52wk Range:	12.97 - 27.11
Bid:	18.47 x 200	Volume:	113,279
Ask:	18.49 x 100	Avg Vol (3m):	253,400
1y Target Est:	19.57	Market Cap:	259.94M
Beta:	2.01	P/E (ttm):	14.12
Next Earnings Date:	8-May-12	EPS (ttm):	1.31
		Div & Yield:	N/A (N/A)

Quotes delayed, except where indicated otherwise. Currency in USD

EXHIBIT – 3

MED

Medifast Inc. (MED) - NYSE

Add to Portfolio Like 9

17.75 ↓0.38 (2.10%) 12:42PM EDT - Nasdaq Real Time Price

Insider Transactions

Get Insider Transactions for: GO

Net Share Purchase Activity

Insider Purchases - Last 6 Months

	Shares	Trans
Purchases	N/A	0
Sales	3,000	1
Net Shares Purchased (Sold)	(3,000)	1
Total Insider Shares Held	1.52M	N/A
% Net Shares Purchased (Sold)	(0.2%)	N/A

Net Institutional Purchases - Prior Qtr to Latest Qtr

	Shares
Net Shares Purchased (Sold)	(8,127,190)
% Change in Institutional Shares Held	(580.69%)

Data provided by Thomson Financial

Insider Transactions Reported - Last Two Years

Date	Insider	Shares	Type	Transaction	Value
Nov 17, 2011	LAVIN GEORGE Director	2,000	Direct	Sale at $14.08 per share.	28,160
Sep 1, 2011	LAVIN GEORGE Director	3,000	Direct	Sale at $15.12 per share.	45,360
Aug 11, 2011	BONDROFF BARRY B Director	1,500	Direct	Acquisition (Non Open Market) at $16.82 per share.	25,230
Jun 19, 2011	REECE JERRY D Director	1,482	Direct	Acquisition (Non Open Market) at $22.40 per share.	33,196
Jun 19, 2011	GROVES JASON L Director	946	Direct	Acquisition (Non Open Market) at $22.40 per share.	21,190
Jun 19, 2011	BARNUM HARVEY C JR Director	1,482	Direct	Acquisition (Non Open Market) at $22.40 per share.	33,196
Jun 19, 2011	MAGUIRE CATHERINE T Director	1,036	Direct	Acquisition (Non Open Market) at $22.40 per share.	23,206
Jun 19, 2011	LAVIN GEORGE Director	1,393	Direct	Acquisition (Non Open Market) at $22.40 per share.	31,203
Jun 19, 2011	MILLS JEANETTE M. Director	1,750	Direct	Acquisition (Non Open Market) at $22.40 per share.	39,200
Jun 19, 2011	CONNOLLY CHARLES P Director	1,393	Direct	Acquisition (Non Open Market) at $22.40 per share.	31,203
Jun 19, 2011	MCDANIEL JOHN P Director	1,571	Direct	Acquisition (Non Open Market) at $22.40 per share.	35,190
Jun 19, 2011	MACDONALD MICHAEL C Director	1,393	Direct	Acquisition (Non Open Market) at $22.40 per share.	31,203
Jun 19, 2011	BONDROFF BARRY B Director	1,493	Direct	Acquisition (Non Open Market) at $22.40 per share.	33,443

Jan 11, 2011	LAVIN GEORGE Director	1,200	Direct	Sale at $26.23 per share.	31,476
Jan 4, 2011	CONNORS BRENDAN Officer	20,000	Direct	Sale at $29.13 per share.	582,600
Jan 4, 2011	MCDEVITT MICHAEL S Officer	95,000	Direct	Sale at $27.88 per share.	2,648,600
Jan 4, 2011	MACDONALD BRADLEY T Officer	50,000	Direct	Sale at $28.72 per share.	1,436,000
Jan 4, 2011	SHEETZ MARGARET MACDONALD Officer	15,000	Direct	Sale at $29.07 per share.	436,050
Jan 4, 2011	SHEETZ MARGARET MACDONALD Officer	10,000	Direct	Disposition (Non Open Market) at $29.07 per share.	290,700
Dec 22, 2010	BONDROFF BARRY B Director	1,000	Direct	Sale at $30.82 per share.	30,820
Nov 28, 2010	WILLIAMS LEO Officer	1,000	Direct	Sale at $24.10 per share.	24,100
Aug 29, 2010	MCDANIEL JOHN P Director	1,000	Direct	Acquisition (Non Open Market) at $26.84 per share.	26,840
Aug 25, 2010	MCDANIEL JOHN P Director	1,000	Direct	Acquisition (Non Open Market) at $27.94 per share.	27,940
Aug 15, 2010	MCDANIEL JOHN P Director	1,000	Direct	Acquisition (Non Open Market) at $28.19 per share.	28,190
May 31, 2010	SHEETZ MARGARET MACDONALD Officer	10,000	Direct	Sale at $30.85 per share.	308,500
May 26, 2010	SHEETZ MARGARET MACDONALD Officer	10,000	Direct	Disposition (Non Open Market) at $32.59 per share.	325,900
May 17, 2010	MACDONALD BRADLEY T Director	20,000	Direct	Disposition (Non Open Market) at $35.08 per share.	701,600
May 11, 2010	MACDONALD SHIRLEY Other	133,402	Direct	Sale at $35.20 per share.	4,695,750

Data provided by EDGAR Online

* = Where indicated, some values are estimates.
[1]= Potential proceeds estimated by the filer.
[2]= Estimated based on the average of multiple prices reported.
[3]= Multiple dates reported. Most recent date shown.

Currency in USD.

All Major Holders - Insider Roster

EXHIBIT – 4

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA
Case No. 11-20209-CR-SEITZ/O'SULLIVAN

UNITED STATES OF AMERICA

vs.

BARRY MINKOW,

Defendant.
_____/

PLEA AGREEMENT

The United States Attorney's Office for the Southern District of Florida ("Office") and Barry Minkow (hereinafter referred to as the "defendant") enter into the following agreement:

1. The defendant agrees to plead guilty to a one count Information charging conspiracy to commit securities fraud, in violation of Title 18, United States Code, Section 371.

2. The defendant is aware that the sentence will be imposed by the Court after considering the Federal Sentencing Guidelines and Policy Statements (hereinafter "Sentencing Guidelines"). The defendant acknowledges and understands that the Court will compute an advisory sentence under the Sentencing Guidelines and that the applicable guidelines will be determined by the Court relying in part on the results of a Pre-Sentence Investigation by the Court's probation office, which investigation will commence after the guilty plea has been entered. The defendant is also aware that, under certain circumstances, the Court may depart from the advisory sentencing guideline range that it has computed, and may raise or lower that advisory sentence under the Sentencing Guidelines. The defendant is further aware and understands that the Court is required to consider the advisory guideline range determined under the Sentencing Guidelines, but is not bound to impose that

sentence. The Court is permitted to tailor the ultimate sentence in light of other statutory concerns, and such sentence may be either more severe or less severe than the Sentencing Guidelines' advisory sentence. Knowing these facts, the defendant understands and acknowledges that the Court has the authority to impose any sentence within and up to the statutory maximum authorized by law for the offense(s) identified in paragraph one (1) and that the defendant may not withdraw the plea solely as a result of the sentence imposed.

3. The defendant also understands and acknowledges that the Court may impose a statutory maximum term of imprisonment of up to five (5) years, followed by a term of supervised release of up to three (3) years. In addition to a term of imprisonment and supervised release, the Court may impose a maximum fine of up to $250,000, or not more than the greater of twice the gross gain or gross loss resulting from the offense set forth in paragraph one (1) above.

4. The defendant further understands and acknowledges that, in addition to any sentence imposed under paragraph three (3) of this agreement, a special assessment in the amount of $100.00 will be imposed on the defendant. The defendant agrees that any special assessment imposed shall be paid by the time of sentencing.

5. The defendant understands that restitution under Title 18, United States Codes, Section 3663A is mandatory and he agrees that the restitution required as a result of the offense set forth in paragraph one (1) above shall be equal to the amount of any actual victim loss attributable to the defendant's knowing participation in this offense, as determined at sentencing. The defendant agrees that offenses against property listed under Title 18, United States Code, Section 3663A, were committed by him as part of the fraud scheme set forth in paragraph one (1) above, and that those offenses gave rise to this plea agreement. The defendant further agrees, as permitted by Title 18,

United States Code, Section 3663A(a)(3), that restitution payable by him shall be payable for the full amount of the actual loss arising from the relevant conduct related to this matter, not just from the offense of conviction.

6. The Office reserves the right to inform the Court and the probation office of all facts pertinent to the sentencing process, including all relevant information concerning the offenses committed, whether charged or not, as well as concerning the defendant and the defendant's background. Subject only to the express terms of any agreed-upon sentencing recommendations contained in this agreement, this Office further reserves the right to make any recommendation as to the quality and quantity of punishment.

7. Although the Office believes that there is no basis for a variance, the defendant may seek or argue for any variance. Although the Office believes that there is no basis for an adjustment, the defendant may seek or argue for an adjustment. Although the Office believes that there is no basis for a departure, the defendant may seek or argue for a departure.

8. This Office agrees that, although not binding on the probation office or the Court, that the Court reduce by two levels the sentencing guideline level applicable to the defendant's offense, pursuant to Section 3E1.1(a) of the Sentencing Guidelines, based upon the defendant's recognition and affirmative and timely acceptance of personal responsibility. If at the time of sentencing the defendant's offense level is determined to be sixteen (16) or greater, the government will make a motion requesting an additional one level decrease pursuant to Section 3E1.1(b) of the Sentencing Guidelines, stating that the defendant has assisted authorities in the investigation or prosecution of his own misconduct by timely notifying authorities of his intention to enter a plea of guilty, thereby permitting the government to avoid preparing for trial and permitting the government and the court

to allocate their resources efficiently. The United States, however, will not be required to make this motion or any of the recommendations set forth in this paragraph if the defendant: (a) fails or refuses to make a full, accurate and complete disclosure to the probation office of the circumstances surrounding the relevant offense conduct; (b) is found to have misrepresented facts to the government prior to entering into this plea agreement; or, (c) commits any misconduct after entering into this plea agreement, including but not limited to committing a state or federal offense, violating any term of release, or making false statements or misrepresentations to any governmental entity or official.

9. This Office and the defendant agree, although not binding on the probation office or the Court, they will jointly recommend that the Court make the following findings and conclusions as to the sentence to be imposed on the count to which the defendant shall plead:

a. Applicable Guideline Offense and Base Offense Level: The offense guideline applicable to the defendant's offense is Sentencing Guidelines Section 2B1.1(a)(1), which provides for a base offense level of six (6) because the defendant will plead guilty to conspiracy to commit securities fraud, which carries a maximum term of imprisonment of five (5) years.

b. Specific Offense Characteristics: The parties agree and stipulate that the following offense characteristics apply under Section 2B1.1(b):

(i) Loss - The parties agree that a reasonable estimate of the reasonably foreseeable pecuniary harm that resulted from the offense was greater than

$400,000,000,[1] increasing the offense level by thirty (30) under Section 2B1.1(b)(1)(P);

(ii) Sophisticated Means - The parties agree that the offense involved sophisticated means, increasing the offense level by two (2) under Section 2B1.1(b)(9)(C).

c. Role in the Offense: The parties agree and stipulate that the following role characteristic applies under Section 3B1.3:

(i) Abuse of Position of Trust - The parties agree that the defendant abused a position of public or private trust in a manner that specifically facilitated the commission or concealment of the offense, increasing the offense level by two (2) under Section 3B1.3.

10. This agreement excludes Title 26 offenses, crimes of violence, and any other proceeding which may be pending at the time this agreement is signed. This agreement is also limited to the United States Attorney's Office for the Southern District of Florida and, as such, does not and cannot bind other federal, state, regulatory, or local prosecuting authorities.

11. The defendant is aware that the sentence has not yet been determined by the Court. The defendant also is aware that any estimate of the probable sentencing range or sentence that the defendant may receive, whether that estimate comes from the defendant's attorney, this Office, or the probation office, is a prediction, not a promise, and is not binding on this Office, the probation

[1] For the limited purpose of the sentencing hearing in this criminal matter, the parties agree that the Office possesses sufficient information to prove that Lennar Corporation suffered a loss of approximately $583,573,600. This estimate of loss approximates the artificial diminution in the value of Lennar Corporation equity securities or other corporate assets during the relevant time period. Defense counsel is expressly authorized to argue that all or a portion of this loss was mitigated after disclosure of the offense conduct for the purposes of determining the appropriate restitution amount under paragraph 5 of this agreement.

office or the Court. The defendant understands further that any recommendation that this Office makes to the Court as to sentencing, whether pursuant to this agreement or otherwise, is not binding on the Court and the Court may disregard the recommendation in its entirety. The defendant understands and acknowledges, as previously acknowledged in paragraph two (2) above, that the defendant may not withdraw his plea based upon the Court's decision not to accept a sentencing recommendation made by the defendant, this Office, or a recommendation made jointly by both the defendant and this Office.

12. In the event the defendant withdraws from this agreement prior to or after pleading guilty to the charges identified in paragraph one (1) above, or should this Office, in its sole discretion, determine that the defendant has failed to fully comply with any of the terms of this plea agreement, this Office will be released from its obligations under this agreement, and the defendant agrees and understands that: (a) the defendant thereby waives any protection afforded by any proffer letter agreement between the parties, Section 1B1.8 of the Sentencing Guidelines, Rule 11(f) of the Federal Rules of Criminal Procedure, and Rule 410 of the Federal Rules of Evidence, (b) that any statements made by the defendant as part of plea discussions, any debriefings or interviews, or in this agreement, whether made prior to or after the execution of this agreement, will be admissible against him without any limitation in any civil or criminal proceeding brought by the government; (c) the defendant's waiver of any defense based on the statute of limitations, including the waiver set forth below in paragraph 13, or any other defense based on the passage of time in filing an indictment or information, referred to herein, shall remain in full force and effect; (d) the defendant stipulates to the admissibility and authenticity, in any case brought by the United States in any way related to the facts referred to in this agreement, of any documents provided by the defendant or the

defendant's representatives to any state or federal agency and/or this Office; and (e) the defendant further stipulates to the admissibility, in any case brought by the United States in any way related to the facts referred to in this agreement, of the entire factual basis set forth below in paragraph 16, as the defendant's own statement.

13. The defendant hereby knowingly and voluntarily waives any defense based on the statute of limitations or any other defense based on the passage of time in filing an indictment or information against the defendant with respect to any criminal offenses in connection with the defendant's criminal conduct described in paragraph one (1) above.

14. The defendant is aware that Title 18, United States Code, Section 3742 affords the defendant the right to appeal the sentence imposed in this case. Acknowledging this, in exchange for the undertakings made by this Office in this plea agreement, the defendant hereby waives all rights conferred by Section 3742 to appeal any sentence imposed, including any restitution order, or to appeal the manner in which the sentence was imposed, or to collaterally attack the conviction pursuant to Title 28, United States Code, Sections 2255, 2254, 2241 or any other applicable provision, unless the sentence exceeds the maximum permitted by statute or is the result of an upward departure from the guideline range that the Court establishes at sentencing. The defendant further understands that nothing in this agreement shall affect the government's right and/or duty to appeal as set forth in Title 18, United States Code, Section 3742(b). However, if this Office appeals

the defendant's sentence pursuant to Section 3742(b), the defendant shall be released from the above waiver of appellate/collateral attack rights. By signing this agreement, the defendant acknowledges that he has discussed the appeal/collateral attack waiver set forth in this agreement with his attorney. The defendant further agrees, together with this Office, to request that the district court enter a specific finding that the defendant's waiver of his right to appeal or to collaterally attack the conviction or sentence to be imposed in this case was knowing and voluntary.

15. This Office agrees that it will not seek additional upward specific offense characteristics, enhancements, or upward departures to or from the defendant's offense level beyond those, if any, specifically referred to in this agreement, except that this Office shall have the right in its discretion to seek additional upward specific offense characteristics, enhancements, or upward departures to or from the defendant's offense level beyond those, if any, specifically referred to in this agreement where any such additional upward specific offense characteristics, enhancements, or upward departures to or from the defendant's offense level would be based on conduct occurring after the defendant enters into this agreement. The defendant agrees that he will be sentenced under the Sentencing Guidelines and will not seek additional downward specific offense characteristics, reductions, variances, or downward departures to or from the defendant's offense level beyond those, if any, specifically referred to in this agreement. However, in the event the probation office recommends any specific offense characteristics, enhancements, reductions, or departures to or from the defendant's offense level other than those, if any, specifically referred to in this agreement, either party shall have the right but not the obligation to oppose any such recommendation.

16. The defendant hereby (i) confirms that he has reviewed the following facts with legal counsel, (ii) adopts the following factual summary as his own statement, (iii) agrees that the following facts are true and correct, and (iv) stipulates that the following facts provide a sufficient factual basis for the plea of guilty in this case, in accordance with Rule 11(b)(3) of the Federal Rules of Criminal Procedure:

> From January 2009 through March 2009, Barry Minkow, Conspirator A, and others conspired to execute a scheme and artifice to defraud Lennar Corporation and others in connection with securities issued by Lennar Corporation[3] and to obtain, by means of false or fraudulent pretenses, representations, or promises, money or property from Lennar Corporation in connection with the purchase or sale of securities issued by Lennar Corporation.
>
> Prior to the conspiracy described below, Minkow was a convicted felon who previously served a term of incarceration in a federal prison. Following his release from prison, Minkow claimed to be a reformed fraudster whose experience and expertise would allow him to assist law enforcement to find and fight corporate fraud. In this role, Minkow established a formal relationship with one or more federal law enforcement agencies as a "source." As a result of this relationship, Minkow held a position of public or private trust. This position gave Minkow access to material non-public information in the possession of a federal law enforcement agency, the use of which was restricted.
>
> Prior to Minkow's participation in this conspiracy, an individual referred to herein as Conspirator A publicly asserted that Lennar Corporation owed him a substantial sum of money as a result of a failed business deal. When Conspirator A was unsuccessful at obtaining a judgement in a court of law, Conspirator A decided to employ extortionate means to induce Lennar Corporation to pay the demanded sum of money.
>
> On or about July 11, 2008, Conspirator A sent a letter by Federal Express to the Board of Directors of Lennar Corporation in Miami-Dade County in the Southern District of Florida. In this letter,

[3] Lennar Corporation is an issuer with a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934.

Conspirator A threatened to "air... dirty little secrets" of individual Lennar Corporation executives if Lennar Corporation failed to capitulate to Conspirator A's demands for money or property. Further, Conspirator A threatened to cause the Securities and Exchange Commission or other agencies of the federal government to "launch an investigation into all of Lennar's business dealings to see if a... pattern of fraud and deceit occurs" unless Lennar Corporation capitulated to Conspirator A's demands.

When Lennar Corporation refused to capitulate to Conspirator A's extortionate demands, Conspirator A hired Minkow to apply economic pressure on Lennar Corporation by artificially depressing the publicly quoted price of Lennar Corporation's capital stock. In return for payment of a substantial fee, Minkow agreed to assist Conspirator A by, among other things, assisting with the execution of Conspirator A's threats to damage the reputation and character of Lennar Corporation and its individual officers.

To induce Lennar Corporation to capitulate to Conspirator A's demands, Minkow created an internet website styled www.lenn-ron.com. On this internet website, Minkow and others made numerous false and misleading statements about the management and operation of Lennar Corporation.

Additionally, Minkow drafted a report alleging widespread fraud at Lennar Corporation. Minkow created this report adopting Conspirator A's false assertions with reckless disregard for their truth. On or about January 7, 2009, Minkow and others sent this report to agents at multiple federal agencies.

Through the internet website, press releases, e-mail communications, one or more youtube.com videos, and other methods of mass-publication, Minkow and others made false and misleading representations to the investing public about Lennar Corporation's financial condition and business structure. Further, Minkow and others made false and misleading statements about the personal character of Lennar Corporation's management, alleging, among other things, that managers used offshore accounts to conceal the proceeds of a fraud.

Minkow and others employed existing relationships with analysts and market participants in the execution of this conspiracy. For instance, Minkow and others informed an analyst that Minkow and others were meeting with 60 Minutes, an investigative news

show, to discuss fraud at Lennar Corporation. Despite the fact that many of Minkow's allegations were unsubstantiated and vague, the scope of the allegations and Minkow's public stature created "headline risk" that materially and fraudulently depressed the value of Lennar Corporation's common stock.

Once it became clear that Minkow's actions were materially impacting Lennar Corporation's stock price, representatives for Conspirator A offered to have Minkow retract his damaging fraud allegations in return for a payment of cash and Lennar Corporation common stock. As evidence of the positive effect of such a retraction, Conspirator A's representatives pointed to the experience of one or more other corporations that were the subject of similar allegations (and a subsequent retraction) by Minkow in recent years.

In March 2009, Minkow further abused his relationship with federal law enforcement agents to obtain and misappropriate material non-public information related to Lennar Corporation. Specifically, Minkow used his relationship with the Federal Bureau of Investigation to obtain specific, material non-public information about the existence of an investigation arising from Minkow's own January 7, 2009 report. Despite the fact that Minkow had a well-known duty to refrain from trading securities based on this information, Minkow transferred funds from a Morgan Stanley trading account to a trading account located in the Southern District of Florida held in a nominee's name. Thereafter, Minkow misappropriated material non-public information for his own personal gain by executing numerous trades in options contracts (SSFs) related to securities issued by Lennar Corporation.

On March 16, 2009, Minkow used a nominee account in the Southern District of Florida to execute multiple trades in Lennar Corporation options contracts. An internal communication at the broker-dealer described Minkow's position as a "risky highly concentrated position in Lennar SSF's... [comprised of] over 150 contracts..."

17. The defendant agrees that he shall cooperate fully with this Office by:

a. providing truthful and complete information and testimony, and producing documents, records and other evidence, when called upon by this Office, whether in interviews, before a grand jury, or at any trial or other court proceeding;

b. appearing at such grand jury proceedings, hearings, trials, and other judicial proceedings, and at meetings, as may be required by this Office;

c. if requested by this Office, working in an undercover role to contact and negotiate with others suspected and believed to be involved in criminal misconduct, under the supervision of, and in compliance with, law enforcement officers and agents,

d. in providing information and testimony, he will not seek to protect any person or entity through false information or omission, and will not falsely implicate any person or entity.

18. The defendant also agrees that the defendant shall assist this Office in all proceedings, whether administrative or judicial, involving the forfeiture to the United States of all rights, title, and interest, regardless of their nature or form, in all assets, including real and personal property, cash and other monetary instruments, wherever located, which the defendant or others her knowledge have accumulated as a result of illegal activities. Such assistance will involve an agreement on defendant's part to the entry of an order enjoining the transfer or encumbrance of assets which may be identified as being subject to forfeiture. Additionally, defendant agrees to identify as being subject to forfeiture all such assets, and to assist in the transfer of such property to the United States by delivery to this Office upon this Office's request, all necessary and appropriate documentation with respect to said assets, including consents to forfeiture, quit claim deeds and any and all other documents necessary to deliver good and marketable title to said property.

19. The defendant also understands and agrees that he will not commit any further crimes. The defendant further understands that he may be prosecuted for, without limitation, any materially

false statement made at any time during his cooperation with the United States, including under the federal perjury, obstruction of justice, and false statements statutes.

20. In addition, should the defendant falsely implicate or incriminate any person, or should the defendant fail to voluntarily and reasonably disclose all information and provide full and complete cooperation, which determinations are within the sole discretion of the United States, this Agreement is voidable at the option of the United States, and the following conditions shall then also apply:

a. The defendant may be prosecuted for perjury or false statements, if any, committed while testifying pursuant to this Agreement or for obstruction of justice should he commit these offenses during the time in which he is cooperating with law enforcement pursuant to this Agreement;

b. The United States may use against the defendant his own admissions and statements and the information, books, papers, documents and objects that he himself has furnished in the course of his cooperation with the United States.

21. This Office reserves the right to evaluate the nature and extent of the defendant's cooperation and to make the defendant's cooperation, or lack thereof, known to the court at the time of sentencing. If in the sole and unreviewable judgment of this Office the defendant's cooperation is of such quality and significance to the investigation or prosecution of other criminal matters as to warrant the court's downward departure from the sentence required by the Sentencing Guidelines, this Office may at or before sentencing make a motion pursuant to Title18, United States Code, Section 3553(e), Section 5K1.1 of the Sentencing Guidelines, or Rule 35 of the Federal Rules of Criminal Procedure subsequent to sentencing, reflecting that the defendant has provided substantial

assistance and recommending sentence reduction. The defendant acknowledges and agrees, however, that nothing in this Agreement may be construed to require this Office to file such a motion and that this Office's assessment of the nature, value, truthfulness, completeness, and accuracy of the defendant's cooperation shall be binding on the defendant.

22. The defendant understands and acknowledges that the court is under no obligation to grant a government motion pursuant to Title 18, United States Code, Section 3553(e), 5K1.1 of the Sentencing Guidelines or Rule 35 of the Federal Rules of Criminal Procedure, as referred to in this agreement, should the government exercise its discretion to file such a motion.

23. This is the entire agreement and understanding between this Office and the defendant. There are no other agreements, promises, representations, or understandings.

WIFREDO A. FERRER
UNITED STATES ATTORNEY

Date: 3/22/2011 By: _____
RYAN DWIGHT O'QUINN
ASSISTANT UNITED STATES ATTORNEY

Date: _____ By: _____
DONALD RE
ATTORNEY FOR DEFENDANT

Date: 3/22/11 By: _____
ALVIN ENTIN
ATTORNEY FOR DEFENDANT

Date: 3/22/11 By: _____
BARRY MINKOW
DEFENDANT

EXHIBIT – 5

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

JEFF POKORNY, LARRY BLENN and KENNETH BUSIERE on behalf of themselves and those similarly situated,

Plaintiffs,

v.

QUIXTAR INC., *et al.*,

Defendants.

Case No. C 07-00201 SC

~~[PROPOSED]~~ ORDER GRANTING JOINT MOTION FOR PRELIMINARY APPROVAL OF CLASS ACTION SETTLEMENT AGREEMENT AND FINDING OF GOOD FAITH SETTLEMENT

WHEREAS, this matter has come before the Court pursuant to a Joint Motion for Preliminary Approval of Amended Class Action Settlement Agreement ("Joint Motion");

WHEREAS, the Court finds that it has jurisdiction over this action and each of the parties under 28 U.S.C. § 1331 and that venue is proper in this district;

WHEREAS, the terms of the proposed Settlement of this action are set forth in an Amended Class Action Settlement Agreement ("Settlement Agreement") dated April 29, 2011, executed by counsel for the named Plaintiffs and Quixtar and by certain non-parties, and submitted to the Court by a joint motion (Dkt. No. 162);[1]

WHEREAS, the Court requested and received supplemental briefing from the parties (Dkt. Nos. 203, 207), conducted hearings on June 24, 2011 and January 13, 2012 with regard to the proposed Settlement of this action, and has fully considered the record of these proceedings, the representations, argument, and recommendations of counsel for the moving parties, and the requirements of law;

THE COURT HEREBY ORDERS AS FOLLOWS:

I. CERTIFICATION OF A SETTLEMENT CLASS.

Solely for purposes of the proposed Settlement, the Court finds on a preliminary basis that the requirements of Rule 23 of the Federal Rules of Civil Procedure and any other applicable law have been met with respect to the Settlement Class. Specifically, the Court preliminarily finds that the requirements of Federal Rule of Civil Procedure 23 are satisfied with respect to the following class, and that certification of this class is appropriate under Federal Rules of Civil Procedure 23(a) and 23(b)(3):

> All Persons who, at any time during the Class Period, were (i) an IBO or (ii) a legal entity through which an IBO conducted a Quixtar-related business. Excluded from the Settlement Class are Quixtar, the Identified BSM Companies, their owners, shareholders, family members, and affiliates.

[1] Unless otherwise defined in this Order, the capitalized terms defined in the Settlement Agreement shall have the same meaning in this Order.

The terms "Person," "Class Period," "IBO," "BSM," and "Identified BSM Companies" are defined in the Settlement Agreement. "Person" means an IBO in his or her individual capacity, any corporation, limited liability company, partnership, limited partnership, association, joint stock company, estate, legal representative, trust, unincorporated association, or any business or legal entity through which he or she has conducted or conducts a Quixtar-related business, and their spouses, heirs, predecessors, successors, representatives, alter egos, or assigns. "Class Period" means the period from January 1, 2003, through the date of this Order. "IBO" means any Person within the United States who was an "Independent Business Owner" (as that term is used in Quixtar's business) authorized by Quixtar to own and operate an independent business. "BSM" means motivational and/or training aids in the form of books, magazines, other printed material, audio tapes, video tapes, software, CDs, other electronic media, rallies, meetings, functions, and seminars. "Identified BSM Companies" means the entities and their principal owners that (a) are identified in Paragraph 1.13 of the Settlement Agreement and (b) have executed the Settlement Agreement.

II. APPOINTMENT OF CLASS COUNSEL, CLASS REPRESENTATIVES, AND CLAIMS ADMINISTRATOR.

On a preliminary basis, the Court finds that Plaintiffs' Counsel and the named Plaintiffs satisfy the adequacy requirements of Federal Rule of Civil Procedure 23. Accordingly, the Court preliminarily appoints Plaintiffs' Counsel, Boies, Schiller & Flexner LLP, and Gary, Williams, Finney, Lewis, Watson & Sperando, P.L., as counsel for the Settlement Class and appoints Jeff Pokorny, Larry Blenn, and Kenneth Busiere as class representatives for the Settlement Class.

The Court also approves the parties' selection of Rust Consulting to serve as Claims Administrator for purposes of the Settlement. In accord with the Notice Plan as set forth in the Declaration of David C. Holland Regarding Notice Plan (filed April 29, 2011, Dkt. No. 163-1), the Claims Administrator shall establish and maintain a Settlement Website. The Settlement Website shall contain, among other documents and information, copies of all court filings relating to Settlement approval and to any application for attorneys' fees and reimbursement of expenses.

The Claims Administrator and any Special Master appointed by the Court upon final approval of the Settlement, pursuant to Paragraph 6.1.2 of the Settlement Agreement, shall take reasonable measures to the extent permitted by law to assert and to protect the privacy rights of Settlement Class Members, including by maintaining the confidentiality and security of and preventing the unauthorized access or acquisition of any Forms 1099 and any other financial or personal information submitted in connection with any claim for benefits pursuant to this Settlement Agreement. In the event of any unauthorized access to or acquisition of personal information concerning any Settlement Class Member as a direct result of the intentional or negligent acts or omissions of the Claims Administrator, the Claims Administrator shall be responsible for complying with any privacy, data security, or breach notification obligations under state or federal law, and will be solely responsible for directly providing notice to state agencies, affected Settlement Class Members, and/or others.

III. PRELIMINARY APPROVAL OF THE SETTLEMENT AGREEMENT.

The terms of the Settlement Agreement and all exhibits thereto are preliminarily approved, subject to further consideration prior to or at the Settlement Hearing provided for below. The terms of the Settlement Agreement are sufficiently fair, reasonable, and adequate to be reasonably within the range of approval. As such, the terms of the Settlement Agreement warrant sending notice of the proposed Settlement to members of the Settlement Class.

IV. SETTLEMENT CLASS NOTICE AND PROOF OF CLAIM FORM.

On April 29, 2011, the parties submitted: a long form Notice of Proposed Settlement to be posted to the Settlement web site; Summary Notices to be published nationwide and to be disseminated individually to the members of the Settlement Class by email and/or postcard; and a Claim Form, attached to the Settlement Agreement as Exhibits A, B and C, respectively. (Dkt. Nos. 162-3, 162-4, 162-5.) These were amended in the supplemental filings made on November 16, 2011 by Plaintiffs (Dkt. No. 207).

Following the January 13, 2012 hearing, and again following the Court's telephone order of January 25, 2012, the parties further revised the class notices and prepared a Spanish translation, as directed by the Court. The Court finds that the revised Notices and the Claim

Forms attached hereto as Exhibits A (email notice), B (postcard notice), C (publication notice), D (long form notice), E (Claim Form), F (Spanish version of long form notice), and G (Spanish version of Claim Form) fairly and adequately: (1) describe the terms and effect of the Settlement Agreement and the proposed allocation of the benefits provided to the Settlement Class pursuant to the Settlement; (2) notify the Settlement Class that Class Counsel will seek attorneys' fees in an amount not to exceed $15 million, reimbursement of expenses, and compensation for each named Plaintiff, and that such fees, expenses, and compensation shall be paid from the $34 Million Cash Fund to be established and funded by Quixtar in connection with the Settlement; (3) give notice to the Settlement Class of the time and place of the Settlement Hearing; (4) describe how the members of the Settlement Class may object to any of the terms of the Settlement Agreement and/or any application for an award of attorneys' fees and reimbursement of expenses to Class Counsel; and (5) advise Settlement Class members of their right to exclude themselves from the Settlement Class and of the procedure for doing so. The Court finds that the revised Notices and Claim Forms constitute valid, due, and sufficient notice to the members of the Settlement Class and comply with Rule 23 of the Federal Rules of Civil Procedure and any other applicable law.

In addition, the Court approves the plan of class notice set forth in the parties' Joint Motion and the supporting memoranda submitted by the parties as the best notice practicable under the circumstances. Accordingly, the Court directs that:

- Notice to persons falling within the definition of the Settlement Class shall be effected by the Claims Administrator and shall be structured to be as efficient as possible and to make use of electronic mail and electronic claims submission as provided in the Notice Plan.
- The Notice Plan as set forth in the Declaration of David C. Holland Regarding Notice Plan (filed April 29, 2011, Dkt. No. 163-1; *see also* Supplemental Declaration of Shannon R. Wheatman, Ph.D. on Settlement Notice Plan, Dkt. No. 207-7) is the "best notice practicable under the circumstances" within the meaning of Federal Rule of Civil Procedure 23(c) and is hereby adopted.

- All expenses arising from dissemination of any Notices required by this Order to members of the Settlement Class shall be paid from the $34 Million Cash Fund to be established by Quixtar in connection with the proposed Settlement.

V. SCHEDULE.

The following schedule is approved for notice, objections, briefing, and hearing on the final approval of the Settlement. The Court orders that:

- Upon entry of this Order, Notice to the Class, in all its forms, as approved in Section IV of this Order, shall be promptly disseminated to members of the Settlement Class and/or published in accord with the Notice Plan, and in any event shall be fully effectuated by May 18, 2012.
- By May 27, 2012, Class Counsel shall file any application for an award of attorneys' fees, reimbursement of expenses, and compensation for the named Plaintiffs, and shall cause the application to be promptly posted on the www.QuixtarClass.com website.
- By August 17, 2012, any member of the Settlement Class who wishes to object to the Settlement or to the award of attorneys' fees or reimbursement of expenses to Class Counsel and who wishes to be heard at the Settlement Hearing must file with the Claims Administrator a written notice of his, her, or its intention to appear at the Settlement Hearing and state the basis for the objections.
- By August 17, 2012, any member of the Settlement Class who wishes to be excluded from the Settlement Class must submit a valid exclusion request to the Claims Administrator, in compliance with the instructions in the Notice of Proposed Settlement.
- Any member of the Settlement Class who wishes to participate in the $34 Million Cash Fund or the $21 Million Product Credit established pursuant to the Settlement Agreement must submit a valid, properly executed, and complete Claim Form, substantially in the form attached as Exhibit E or Exhibit G hereto. To be effective, a Claim Form submitted by a member of the Settlement Class

must be transmitted (if sent electronically) or postmarked (if sent by mail) by August 17, 2012.

- Claim forms, objections, and requests for exclusion shall be sent to the address indicated in the notices.
- The Claims Administrator will timely provide copies of any objections or requests for exclusion from the Settlement Class to lead counsel for all parties: Stuart Singer, Boies, Schiller & Flexner LLP, for plaintiffs; Cedric Chao, Morrison & Foerster LLP, for defendant Quixtar; J. William Blue, Jr., Northen Blue L.L.P., for the Britt defendants; and C. Matthew Andersen, Winston & Cashatt, for the Puryear defendants.
- By October 12, 2012, the parties shall file any joint or separate motion(s) for final approval of the proposed Settlement, for entry of the proposed Consent Judgment, and for dismissal of this action on the merits and with prejudice.
- Any responses to the motion(s) for final approval of the proposed Settlement, for entry of the proposed Consent Judgment, and for dismissal of this action on the merits and with prejudice shall be filed by October 26, 2012, and any reply papers in support of the motion(s) must be filed by November 2, 2012.
- Any opposition by any party to Class Counsel's application for an award of attorneys' fees, reimbursement of expenses, and compensation for the named Plaintiffs shall be filed by October 26, 2012 and any reply papers in support of the application shall be filed by November 2, 2012.
- On November 16, 2012, the Court shall conduct a Settlement Hearing, at which it will consider whether the Settlement should be finally approved as fair, reasonable, and adequate, whether the proposed Consent Judgment should be entered, and whether this action should be dismissed on the merits and with prejudice. At the Settlement Hearing, the Court shall also hear any motion by Class Counsel for attorneys' fees, reimbursement of expenses, and compensation

for the named Plaintiffs, and shall hear any objections to that motion or to the proposed Settlement.

- Members of the Settlement Class who do not submit a valid and timely request for exclusion from the Settlement Class shall be bound by any Consent Judgment entered by the Court in this action and, upon the Effective Date of the Settlement, shall be subject to the Release set forth in the Settlement Agreement.
- The Court may, from time-to-time and without further notice to members of the Settlement Class, continue or adjourn the Settlement Hearing.

VI. SECOND AMENDED COMPLAINT.

By their Joint Motion, Defendants and Plaintiffs consent to the filing of the Second Amended Complaint, the effectiveness of which is governed by the Settlement Agreement. Accordingly, under Federal Rule of Civil Procedure 15(a), Plaintiffs may file the Second Amended Complaint upon entry of this Order.

VII. TERMINATION OF THE PROPOSED SETTLEMENT.

If the proposed Settlement is terminated for any reason, this Order shall become null and void and shall be without prejudice to the rights of the parties to the Settlement Agreement, all of whom shall be restored to their previous respective positions in accord with Section 14.3 of the Settlement Agreement.

VIII. USE OF THIS ORDER.

This Order shall not be construed or used as an admission, concession, or declaration by or against Quixtar or any of the Identified BSM Companies of any finding of fault, wrongdoing, or liability. This Order shall not be construed or used as a waiver or admission as to any arguments or defenses that might be available to Quixtar or any of the Identified BSM Companies, including any objections to class certification in the event that the Settlement Agreement is terminated.

IX. JURISDICTION.

The Court shall retain jurisdiction for purposes of implementing the provisions of this Order, and reserves the right to enter additional orders to effectuate the fair and orderly

administration and consummation of the proposed Settlement and to resolve any and all disputes that may arise thereunder.

IT IS SO ORDERED this 21 of Feb., 2012.

Honorable Samuel Conti
United States District Judge

EXHIBIT – 6

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
WESTERN DIVISION

FEDERAL TRADE COMMISSION,
Plaintiff
v.
BURNLOUNGE, INC., et al.,
Defendants.

Case No. **CV 07-3654-GW (FMOx)**

AMENDED FINAL JUDGMENT AND ORDER FOR PERMANENT INJUNCTION AND OTHER EQUITABLE RELIEF AGAINST DEFENDANTS BURNLOUNGE, INC., JUAN ALEXANDER ARNOLD, JOHN TAYLOR AND ROB DEBOER

On June 6, 2007, the Plaintiff, Federal Trade Commission ("FTC" or "Commission") filed a Complaint for Injunctive and Other Equitable Relief against BurnLounge, Inc., Juan Alexander Arnold, John Taylor, Rob DeBoer and Scott Elliot pursuant to Section 13(b) of the Federal Trade Commission Act ("FTC Act"), 15 U.S.C. § 53(b), alleging that they had engaged in deceptive acts or practices in violation of Section 5(a) of the FTC Act, 15 U.S.C. § 45(a). A settlement was agreed upon between the Commission and Defendant Scott Elliot, and the Court entered a stipulated final order for permanent injunction and other equitable relief against him (Docket No. 248) on June 16, 2008.

As to the remaining defendants, the matter proceeded to a nine-day bench trial between December 9, 2008 and December 22, 2008. On March 30, 2009, the Court held a hearing to allow the parties to present closing arguments. On July 1,

2011, the Court issued a Statement of Decision (Docket No. 431) finding by a preponderance of evidence that BurnLounge, Inc., Juan Alexander Arnold, John Taylor, and Rob DeBoer had violated Section 5 of the FTC Act, and that permanent injunctive and equitable monetary relief was warranted pursuant to 15 U.S.C. §§ 45 and 53. The Court directed Plaintiff to resubmit an amended proposed order conforming to the Court's Statement of Decision.

Based on the record established in this matter and for reasons set forth in the Court's Statement of Decision, it is hereby **ORDERED, ADJUDGED AND DECREED:**

DEFINITIONS

For purposes of this Final Judgment and Order for Permanent Injunction and Other Equitable Relief (hereinafter "Final Order"), the following definitions shall apply:

1. "Business opportunity" means:
   - (a) A commercial arrangement in which the seller solicits a prospective purchaser to enter into a new business;
   - (b) The prospective purchaser makes a required payment; and
   - (c) The seller, expressly or by implication, orally or in writing, represents that the seller or one or more designated persons will:
     - (i) Provide locations for the use or operation of equipment, displays, vending machines, or similar devices, owned, leased, controlled or paid for by the purchaser;
     - (ii) Provide outlets, accounts, or customers, including, but not limited to, Internet outlets, accounts, or customers, for the purchaser's goods or services; or
     - (iii) Buy back any or all of the goods or services that the purchaser makes, produces, fabricates, grows, breeds,

modifies, or provides, including but not limited to providing payment for such services as, for example, stuffing envelopes from the purchaser's home.

2. "Business Venture" means any written or oral business arrangement, however denominated, that is a business opportunity, franchise, or that consists of the payment of any consideration in exchange for: (a) the right or means to offer, sell, or distribute goods or services (regardless of whether identified by a trademark, service mark, trade name, advertising or other commercial symbol); and (b) more than nominal assistance to any person or entity in connection with or incident to the establishment, maintenance, or operation of a new business, or the entry by an existing business into a new line or type of business.

3. "Consumer" means an actual or potential purchaser, customer, subscriber, or natural person.

4. "Defendant BurnLounge" means Defendant BurnLounge, Inc., and its successors and assigns.

5. "Defendant Arnold" means Defendant Juan Alexander Arnold.

6. "Defendant Taylor" means Defendant John Taylor, whose legal name is John Marcus Taylor.

7. "Defendant DeBoer" means Defendant Rob DeBoer, whose legal name is Robert Edwards DeBoer.

8. "Defendants" means Defendants BurnLounge, Inc., Juan Alexander Arnold, John Taylor and Rob DeBoer.

9. "Individual Defendants" means Defendants Arnold, Taylor and DeBoer.

10. The term "document" is synonymous in meaning and equal in scope to the usage of the term in Federal Rule of Civil Procedure 34(a), and includes writings, drawings, graphs, charts, photographs, audio and

video recordings, electronically stored information, computer records, and other data compilations from which information can be obtained and translated, if necessary, through detection devices into reasonably usable form. A draft or non-identical copy is a separate document within the meaning of the term.

11. "Franchise" means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that: (a) the franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark; (b) the franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method or operation; and (c) as a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

12. "Franchisee" means any person who is granted a franchise.

13. "Franchise seller" means a person that offers for sale, sells, or arranges for the sale of a franchise.

14. "Franchisor" means any person who grants a franchise and participates in the franchise relationship.

15. "Material fact" means any fact likely to affect a person's choice of, or conduct regarding, goods, services, or business ventures.

16. "Multi-level Marketing Program" means any marketing program in which participants pay money to the program promoter in return for which the participants obtain the right to: (a) recruit additional

participants, or have additional participants placed by the promoter or any other person into the program participant's downline, tree, cooperative, income center, or other similar program grouping; (b) sell goods or services; and (c) receive payment or other compensation, in whole or in part, based upon the sales of those in the participants downline, tree, cooperative, income center or similar program grouping.

17. "New business" means a business in which the prospective purchaser is not currently engaged, or a new line or type of business.

18. "Participating in any prohibited marketing scheme" includes, but is not limited to, promoting, marketing, advertising, offering for sale, or selling, or assisting others in the offering for sale or selling the right to participate in, the prohibited marketing scheme, as well as acting or serving as an officer, director, employee, salesperson, agent, shareholder, advisor, consultant, independent contractor, or distributor, or acting as a speaker or spokesperson on behalf of, any prohibited marketing scheme.

19. "Prohibited Marketing Scheme" means an illegal pyramid sales scheme (*see e.g., Webster v. Omnitrition Int'l,* 79 F.3d 776, 781 (9th Cir. 1996), Ponzi scheme, chain marketing scheme, or other marketing plan or program in which participants pay money or valuable consideration in return for which they obtain the right to receive rewards for recruiting other participants into the program, and those rewards are unrelated to the sale of products or services to ultimate users. For purposes of this definition, "sale of products or services to ultimate users" does not include sales to other participants or recruits or to the participants' own accounts.

20. "Trademark" means trademarks, service marks, names, logos, and

other commercial symbols.

ORDER

I. Prohibited Marketing Schemes

IT IS THEREFORE ORDERED that each Defendant and their officers, agents, servants, and employees, and those persons in active concert or participation with them who receive actual notice of this Final Order by personal service or otherwise, whether acting directly or through any entity, corporation, subsidiary, division, or other device, are permanently restrained and enjoined from engaging, participating, or assisting in any manner or capacity whatsoever, in any Prohibited Marketing Scheme.

II. Prohibited Representations

IT IS FURTHER ORDERED that, in connection with the advertising, promotion, offering for sale, or sale, or assisting others in the advertising, promotion, offering for sale, or sale of any Multi-level Marketing Program or Business Venture, each Defendant and their officers, agents, servants, and employees, and those persons in active concert or participation with them who receive actual notice of this Final Order by personal service or otherwise, whether acting directly or through any entity, corporation, subsidiary, division, or other device, are permanently restrained and enjoined from making, expressly or by implication, orally or in writing, any false or misleading statement or misrepresentation of material fact including, but not limited to, the following:

A. Misrepresentations about the amount of sales, income, or profits that a participant in such Multi-level Marketing Program or Business Venture can reasonably expect to achieve;

B. Misrepresentations about the amount of sales, income, or profits that a participant or participants in such Multi-level Marketing Program or Business Venture have actually achieved;

C. Misrepresentations about the profitability of participating in such

Multi-level Marketing Program or Business Venture

D. Misrepresentations that a person who participates in such Multi-level Marketing Program or Business Venture can reasonably expect to recoup his or her investment;

E. Misrepresentations of any reward offered to or earned by participants in such Multi-level Marketing Program or Business Venture;

F. Misrepresentations of the legality of such Multi-level Marketing Program or Business Venture; and

G. Misrepresentations of any material aspect of the performance, efficacy, nature, or central characteristic of any good or service offered for sale through such Multi-level Marketing Program or Business Venture.

III. Prohibition Against Material Omissions

IT IS FURTHER ORDERED that (in connection with the advertising, promotion, offering for sale, or sale, or assisting others in the advertising, promotion, offering for sale, or sale of any Multi-level Marketing Program or Business Venture) each Defendant and their officers, agents, servants, employees, and attorneys, whether acting directly or through any entity, corporation, subsidiary, division, or other device, are hereby permanently restrained and enjoined from failing to disclose, clearly and conspicuously, to any participant or prospective participant in any Multi-level Marketing Program or Business Venture to whom any earnings, profits or sales volume claims have been made, the following historical information to the extent that such information is reasonably available to the business:

A. The number and percentage of participants in the Multi-level Marketing Program or Business Venture who have earned, profited or sold at least the amount represented; and

B. The number and percentage of participants in the Multi-level Marketing Program or Business Venture who have made a profit through their

participation in the Multi-level Marketing Program or Business Venture.

IV. Equitable Monetary Relief

IT IS FURTHER ORDERED that:

A. Judgment is hereby entered in favor of the Commission and against Defendants BurnLounge and Arnold, jointly and severally, in the amount of sixteen million two hundred forty-five thousand seven hundred ninety-nine dollars and seventy cents ($16,245,799.70), to be utilized to directly reimburse consumers who were injured by the BurnLounge pyramid scheme, except as provided for in Section V.A. The judgment shall be paid to the Commission within sixty (60) days of entry of this Final Order. Full payment of this sum shall fully satisfy all monetary claims asserted by the Commission against Defendants BurnLounge and Arnold in this matter. Within fifteen (15) days of entry of this Final Order, in partial satisfaction of the judgment, Defendants Arnold and BurnLounge shall do the following:

1. Defendant Arnold shall transfer to the Commission his interest in 1430 N. Cahuega Partners, LP, and all rights and title to that interest; and
2. Defendant BurnLounge shall:
   a. Transfer to the Commission its membership interest in Beatport LLC, and all rights and title to that membership interest; and
   b. Transfer to the Commission all funds owned by BurnLounge or held on its behalf in banks or financial institutions, or otherwise. These funds shall include, but not be limited to, the $50,267.00 and any interest earned thereon, that Defendant BurnLounge was ordered to preserve, pursuant to the Court's Order of August 4, 2008 [Docket No. 268].

B. Judgment is hereby entered in favor of the Commission and against Defendant DeBoer in the amount of one hundred fifty thousand dollars ($150,000.00) as disgorgement. Defendant DeBoer shall disgorge that amount to the Commission within sixty (60) days of entry of this Final Order. Full payment of this sum shall fully satisfy all monetary claims asserted by the Commission against Defendant DeBoer in this matter.

C. Judgment is hereby entered in favor of the Commission and against Defendant Taylor, in the amount of six hundred twenty thousand one hundred thirty-nine dollars and sixty-four cents ($620,139.64) as disgorgement. Defendant Taylor shall disgorge that amount to the Commission within sixty (60) days of entry of this Final Order. Full payment of this sum shall fully satisfy all monetary claims asserted by the Commission against Defendant Taylor in this matter.

D. The judgments entered pursuant to this Section are equitable monetary relief, and are not fines, penalties, punitive assessments or forfeitures.

E. Defendants shall relinquish all dominion, control, and title to the funds or assets paid or transferred pursuant to this Final Order to the fullest extent permitted by law.

F. Pursuant to Section 604(1) of the Fair Credit Reporting Act, 15 U.S.C. § 1681b(1), any consumer reporting agency may furnish consumer reports concerning the Individual Defendants to the FTC, which shall be used for purposes of collecting and reporting on any delinquent amount arising out of this Order.

V. Administration of Funds Collected

IT IS FURTHER ORDERED THAT:

A. Any and all funds collected by the FTC pursuant to this Final Judgment, shall be deposited into a fund administered by the Commission or its agent to be used for consumer redress and any attendant expenses for the administration of any redress fund. Defendants shall have no right to contest the manner of distribution chosen by the Commission. The Commission in its sole

discretion may use a designated agent to administer consumer redress. If the Commission determines in its sole discretion that redress to purchasers is wholly or partially impracticable, or any funds collected from Defendants remain after the redress process is completed, then any funds not used for redress or expenses attendant to the redress fund shall be deposited in the United States Treasury as disgorgement, except as provided in the next paragraph.

The funds used to accomplish the consumer redress (and any costs of administering that redress program) will be initially taken from any moneys and/or property obtained by the FTC from Defendant Arnold pursuant to this Judgment (the "Arnold Funds"). On an annual basis beginning one year after the redress program is established (but beginning, in no event, later than two years after the entry of this Judgment), any Arnold Funds which are not actually paid to consumers as consumer redress or expended as expenses attendant to the implementation of the redress program shall be returned to Defendant Arnold; but in no event shall the amount of returned funds exceed the positive difference of (1) the fair market value of any property plus any cash actually paid to the Commission by Defendant Arnold pursuant to the Judgment, *minus* (2) the sum of $1,664,506.45. *See* footnote 48 of the Statement of Decision in this action (Docket Item No. 431).

B. Defendants shall cooperate fully to assist the Commission in identifying consumers who may be entitled to redress pursuant to this Final Order. The cooperation shall include, but not be limited to, providing Plaintiff a list of each consumer who purchased a VIP, Exclusive or Basic package, and at any time was a BurnLounge Mogul. As to each such consumer, Defendants shall provide consumer contact information including the consumer's name, member and retailer identification numbers, address, telephone numbers and e-mail addresses. This consumer contact information shall be provided to Plaintiff within twenty (20) days of entry of this Final Order in the form of a searchable electronic document

formatted in Microsoft Excel [.xls or .xlsx] or Microsoft Access [.mdb or .mdbx], and supplied on CD-R CD ROM optical disks formatted to ISO 9660 specifications, DVD-ROM optical disks for Windows-compatible personal computers, or USB 2.0 flash drives, or in such other electronic form as may be agreed to in writing by Plaintiff.

VI. Compliance Monitoring

IT IS FURTHER ORDERED that, for the purpose of monitoring and investigating compliance with any provision of this Final Order, and for a period of five (5) years:

A. Within fifteen (15) days of receipt of written notice from a representative of the Commission, Defendants each shall submit additional written reports, which are true and accurate and sworn to under penalty of perjury; produce documents for inspection and copying; appear for deposition; and provide entry during normal business hours to any business location in each Defendant's possession or direct or indirect control to inspect the business operation;

B. In addition, the Commission is authorized to use all other lawful means, including but not limited to:

1. Obtaining discovery from any person, without further leave of court, using the procedures prescribed by Fed. R. Civ. P. 30, 31, 33, 34, 36, 45 and 69;

2. Posing as consumers and suppliers to Defendants, their employees, or any other entity managed or controlled in whole or in part by any Defendant, without the necessity of identification or prior notice; and

C. Defendants shall permit representatives of the Commission to interview any employer, consultant, independent contractor, representative, agent, or employee who has agreed to such an interview, relating in any way to any conduct subject to this Final Order. The person interviewed may have counsel

present.

Provided however, that nothing in this Final Order shall limit the Commission's lawful use of compulsory process, pursuant to Sections 9 and 20 of the FTC Act, 15 U.S.C. §§ 49, 57b-1, to obtain any documentary material, tangible things, testimony, or information relevant to unfair or deceptive acts or practices in or affecting commerce (within the meaning of 15 U.S.C. § 45(a)(1)).

VII. Compliance Reporting

IT IS FURTHER ORDERED that, in order that compliance with the provisions of this Final Order may be monitored:

A. For a period of five (5) years from the date of entry of this Final Order,

1. Each Individual Defendant shall notify the Commission of the following:

   a. Any changes in such Defendant's residence, mailing addresses, and telephone numbers, within ten (10) days of the date of such change;

   b. Any changes in such Defendant's employment status (including self-employment), and any change in such Defendant's ownership in any business entity, within ten (10) days of the date of such change. Such notice shall include the name and address of each business that such Defendant is affiliated with, employed by, creates or forms, or performs services for; a detailed description of the nature of the business; and a detailed description of such Defendant's duties and responsibilities in connection with the business or employment; and

   c. Any changes in such Defendant's name or use of any aliases or fictitious names;

2. Defendant BurnLounge shall notify the Commission of any changes in structure of Defendant BurnLounge or any business entity that Defendant BurnLounge directly or indirectly controls, or has an ownership interest in, that may affect compliance obligations arising under this Final Order, including but not limited to: incorporation or other organization; a dissolution, assignment, sale, merger, or other action; the creation or dissolution of a subsidiary, parent, or affiliate that engages in any acts or practices subject to this Final Order; or a change in the business name or address, at least thirty (30) days prior to such change, provided that, with respect to any proposed change in the business entity about which Defendant BurnLounge learns less than thirty (30) days prior to the date such action is to take place, Defendant BurnLounge shall notify the Commission as soon as is practicable after obtaining such knowledge.

B. One hundred eighty (180) days after the date of entry of this Final Order and annually thereafter for a period of five (5) years, Defendants each shall provide a written report to the FTC, which is true and accurate and sworn to under penalty of perjury, setting forth in detail the manner and form in which they have complied and are complying with this Final Order. This report shall include, but not be limited to:

1. For each Individual Defendant:

a. Such Defendant's then-current residence address, mailing addresses, and telephone numbers;

b. Such Defendant's then-current employment status (including self-employment), including the name, addresses, and telephone numbers of each business that

such Defendant is affiliated with, employed by, or performs services for; a detailed description of the nature of the business; and a detailed description of such Defendant's duties and responsibilities in connection with the business or employment; and

c. Any other changes required to be reported under Subsection A of this Section.

2. For all Defendants:

a. A copy of each acknowledgment of receipt of this Final Order, obtained pursuant to the Section titled "Distribution of Order";

b. Any other changes required to be reported under Subsection A of this Section.

C. Each Defendant shall notify the Commission of the filing of a bankruptcy petition by such Defendant within fifteen (15) days of filing.

D. For the purposes of this Final Order, Defendants shall, unless otherwise directed by the Commission's authorized representatives, send by overnight courier all reports and notifications required by this Final Order to the Commission, to the following address:

Associate Director for Enforcement
Federal Trade Commission
600 Pennsylvania Avenue, N.W., Room NJ-2122
Washington, D.C. 20580
RE: FTC v. BurnLounge, Inc.

Provided that, in lieu of overnight courier, Defendants may send such reports or notifications by first-class mail, but only if Defendants contemporaneously send an electronic version of such report or notification to the Commission at: DEBrief@ftc.gov.

E. For purposes of the compliance reporting and monitoring required by this Final Order, the Commission is authorized to communicate directly with each

Defendant.

VIII. Record Keeping Provisions

IT IS FURTHER ORDERED that, for a period of seven (7) years from the date of entry of this Final Order, Defendants, in connection with advertising, offering, marketing, promotion or sale of any multi-level marketing program or business venture and their agents, employees, officers, or corporations, are hereby restrained and enjoined from failing to create and retain the following records:

A. Accounting records that reflect the cost of goods or services sold, revenues generated, and the disbursement of such revenues;

B. Personnel records accurately reflecting: the name, address, and telephone number of each person employed in any capacity by such business, including as an independent contractor; that person's job title or position; the date upon which the person commenced work; and the date and reason for the person's termination, if applicable;

C. Customer files containing the names, addresses, phone numbers, dollar amounts paid, quantity of items or services purchased, and description of items or services purchased, to the extent such information is obtained and kept in the ordinary course of business;

D. Complaints and refund requests (whether received directly, indirectly, or through any third party) and any responses to those complaints or requests;

E. Copies of all sales scripts, training materials, advertisements, or other marketing materials; and

F. All records and documents necessary to demonstrate full compliance with each provision of this Final Order, including but not limited to, copies of acknowledgments of receipt of this Final Order required by the Sections titled "Distribution of Order" and "Acknowledgment of Receipt of Order" and all reports submitted to the FTC pursuant to the Section titled "Compliance Reporting."

IX. Distribution of Order

IT IS FURTHER ORDERED that, for a period of five (5) years from the date of entry of this Final Order, Defendants shall deliver copies of the Final Order as directed below:

A. Defendant BurnLounge must deliver a copy of this Final Order to (1) all of its principals, officers, directors, and managers; (2) all of its employees, agents, and representatives who engage in conduct related to the subject matter of the Final Order; and (3) any business entity resulting from any change in structure set forth in Subsection A of the Section titled "Compliance Reporting." For current personnel, delivery shall be within five (5) days of service of this Final Order upon Defendant BurnLounge. For new personnel, delivery shall occur prior to them assuming their responsibilities. For any business entity resulting from any change in structure set forth in Subsection A of the Section titled "Compliance Reporting," delivery shall be at least ten (10) days prior to the change in structure.

B. Individual Defendant as Control Person: For any business that an Individual Defendant controls, directly or indirectly, or in which such Defendant has a majority ownership interest, such Defendant must deliver a copy of this Final Order to (1) all principals, officers, directors, and managers of that business; (2) all employees, agents, and representatives of that business who engage in conduct related to the subject matter of the Final Order; and (3) any business entity resulting from any change in structure set forth in Subsection A.2 of the Section titled "Compliance Reporting." For current personnel, delivery shall be within five (5) days of service of this Final Order upon such Defendant. For new personnel, delivery shall occur prior to them assuming their responsibilities. For any business entity resulting from any change in structure set forth in Subsection A.2 of the Section titled "Compliance Reporting," delivery shall be at least ten (10) days prior to the change in structure.

C. Individual Defendant as employee or non-control person: For any business where an Individual Defendant is not a controlling person of the business

but otherwise engages in conduct which is related to or involves multi-level marketing, such Defendant must deliver a copy of this Final Order to all principals and managers of such business before engaging in such conduct.

D. Defendants must secure a signed and dated statement acknowledging receipt of the Final Order, within thirty (30) days of delivery, from all persons receiving a copy of the Final Order pursuant to this Section.

X. Acknowledgment of Receipt of Order

IT IS FURTHER ORDERED that each Defendant, within five (5) business days of receipt of this Final Order as entered by the Court, must submit to the Commission a truthful sworn statement acknowledging receipt of this Final Order.

XI. Independence of Obligations

IT IS FURTHER ORDERED that each of the obligations imposed by this Final Order is independent of all other obligations under the Final Order, and that the expiration of any requirements imposed by this Final Order shall not affect any other obligation arising under this Final Order.

XII. Costs and Attorneys Fees

IT IS FURTHER ORDERED that, except as otherwise provided above, each party to this Final Order bear his or its own costs and attorneys fees incurred in connection with this action.

XIII. Continued Jurisdiction

IT IS FURTHER ORDERED that this Court shall retain jurisdiction

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of this matter for purposes of construction, modification, and enforcement of this Final Order.

Dated: 29th of February, 2012

Hon. George H. Wu
United States District Judge

EXHIBIT – 7

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.

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[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

[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 over-whelming 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 require-ments. 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.

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[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

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[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

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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. BurnLounge'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

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[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

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[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
United States District Judge

EXHIBIT - 8

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2009

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number 0-23016

MEDIFAST, INC.
(Exact name of registrant as specified in its charter)

Delaware	**13-3714405**
(State or other jurisdiction of organization)	**(I.R.S. employer Identification no.)**

11445 Cronhill Drive
Owings Mills, MD 21117
Telephone Number (410) 581-8042

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

Indicate by checkmark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	**Outstanding at May 8, 2009**
Common stock, $.001 par value per share	14,689,960 shares

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MEDIFAST, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	March 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,297,000	$ 1,841,000
Accounts receivable-net of allowance for doubtful accounts of $100,000	574,000	448,000
Inventory	12,363,000	13,856,000
Investment securities	1,129,000	1,099,000
Deferred compensation	451,000	531,000
Prepaid expenses and other current assets	1,925,000	2,034,000
Prepaid income tax	1,091,000	1,131,000
Note receivable - current	180,000	180,000
Deferred tax asset	100,000	100,000
Total Current Assets	**24,110,000**	**21,220,000**
Property, plant and equipment - net	21,626,000	21,709,000
Trademarks and intangibles - net	5,122,000	5,547,000
Deferred tax asset, net of current portion	1,241,000	1,131,000
Note receivable, net of current portion	1,046,000	1,080,000
Other assets	352,000	350,000
TOTAL ASSETS	**$ 53,497,000**	**$ 51,037,000**
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued expenses	$ 4,832,000	$ 5,130,000
Line of credit	3,179,000	3,164,000
Current maturities of long-term debt	257,000	257,000
Total Current liabilities	**8,268,000**	**8,551,000**
Long-term debt, net of current liabilities	4,249,000	4,313,000
Total liabilities	**12,517,000**	**12,864,000**
Stockholders' equity:		
Common stock; par value $.001 per share; 20,000,000 authorized; 14,689,960 and 14,585,960 shares issued and outstanding, respectively	15,000	15,000
Additional paid-in capital	31,227,000	30,787,000
Accumulated other comprehensive (loss)	(447,000)	(389,000)
Retained earnings	17,738,000	15,253,000
	48,533,000	**45,666,000**
Less: cost of 301,092 and 272,192 shares of common stock in treasury, respectively	(2,058,000)	(1,956,000)
Less: unearned compensation	(5,495,000)	(5,537,000)
Total Stockholders' Equity	**40,980,000**	**38,173,000**
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**$ 53,497,000**	**$ 51,037,000**

See accompanying notes to condensed consolidated financial statements.

MEDIFAST, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended March 31, 2009	2008
Revenue	$ 33,680,000	$ 25,169,000
Cost of sales	8,054,000	6,100,000
Gross Profit	**25,626,000**	**19,069,000**
Selling, general, and administration	21,610,000	17,007,000
Income from operations	4,016,000	2,062,000
Other income/(expense)		
Interest expense, net	(5,000)	(65,000)
Other income/(expense)	(35,000)	36,000
	(40,000)	(29,000)
Income before provision for income taxes	**3,976,000**	**2,033,000**
Provision for income tax (expense)	(1,491,000)	(668,000)
Net income	**$ 2,485,000**	**$ 1,365,000**
Basic earnings per share	$ 0.19	$ 0.10
Diluted earnings per share	$ 0.17	$ 0.10

Weighted average shares outstanding -		
Basic	13,284,431	13,101,157
Diluted	14,494,898	13,799,293

See accompanying notes to condensed consolidated financial statements.

MEDIFAST, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Three Months Ended March 31,	
	2009	**2008**
Cash flows from operating activities:		
Net income	$ 2,485,000	$ 1,365,000
Adjustments to reconcile net income to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	1,229,000	1,079,000
Realized (gain) loss on investment securities	(21,000)	36,000
Common stock issued for services	52,000	35,000
Stock options cancelled during period	-	(77,000)
Vesting of unearned compensation	429,000	148,000
Net change in other comprehensive (loss)	(58,000)	(167,000)
Deferred income taxes	(110,000)	18,000
Changes in assets and liabilities:		
Decrease (Increase) in accounts receivable	(126,000)	18,000
Decrease (Increase) in inventory	1,493,000	(792,000)
Decrease (Increase) in prepaid expenses & other current assets	110,000	(518,000)
Decrease in deferred compensation	80,000	91,000
Decrease (Increase) in prepaid taxes	40,000	(143,000)
(Increase) in other assets	(2,000)	(202,000)
(Decrease) Increase in accounts payable and accrued expenses	(297,000)	1,103,000
(Decrease) in income taxes payable	-	(592,000)
Net cash provided by operating activities	**5,304,000**	**1,402,000**
Cash Flow from Investing Activities:		
(Purchase) of investment securities, net	(9,000)	(4,000)
(Purchase) of property and equipment	(722,000)	(2,735,000)
(Purchase) of intangible assets	-	(2,000)
Net cash (used in) investing activities	(731,000)	**(2,741,000)**
Cash Flow from Financing Activities:		
Issuance of common stock, options and warrants	-	12,000
(Repayment) of long-term debt, net	(64,000)	(71,000)
Increase in line of credit	15,000	577,000
Decrease in note receivable	34,000	33,000
(Purchase) of treasury stock	(102,000)	-
Net cash provided by (used in) financing activities	**(117,000)**	**551,000**
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,456,000	(788,000)
Cash and cash equivalents - beginning of the period	1,841,000	2,195,000
Cash and cash equivalents - end of period	$ 6,297,000	$ 1,407,000
Supplemental disclosure of cash flow information:		
Interest paid	$ 37,000	$ 103,000
Income taxes	$ 985,000	$ 1,489,000
Supplemental disclosure of non cash activity:		
Common stock issued to Executives and Directors over 2-6 year vesting periods	$ 429,000	$ 195,000
Options cancelled during period	$ -	$ (77,000)
Common stock issued for services	$ 52,000	$ 35,000

See accompanying notes to condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements

General

1. Basis of Presentation

The condensed unaudited interim consolidated financial statements included herein have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. The condensed consolidated financial statements and notes are presented as permitted on Form 10-Q and do not contain information included in the Company's annual statements and notes. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. It is suggested that these condensed consolidated financial statements be read in conjunction with the December 31, 2008 audited consolidated financial statements and the accompanying notes thereto. While management believes the procedures followed in preparing these condensed consolidated financial statements are reasonable, the accuracy of the amounts are in some respects dependent upon the facts that will exist, and procedures that will be accomplished by the Company later in the year.

These condensed unaudited consolidated financial statements reflect all adjustments, including normal recurring adjustments, which, in the opinion of management, are necessary to present fairly the operations and cash flows for the period presented.

2. Presentation of Financial Statements

The Company's condensed consolidated financial statements include the accounts of Medifast, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

3. Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS No. 141(R)"). SFAS No. 141(R) changes how an entity accounts for the acquisition of a business. While it retains the requirement to account for all business combinations using the acquisition method, the new rule will apply to a wider range of transactions or events and requires, in general, acquisition-date fair value measurement of identifiable assets acquired, liabilities assumed and non-controlling ownership interests held in the acquire, among other items. The Company is beginning to review the provisions of SFAS No. 141(R), which applies prospectively to business combinations with an acquisition date on or after the beginning of its 2009 fiscal year. The adoption of this standard did not have any material impact on condensed consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements: an amendment of ARB No. 51" ("SFAS No. 160"). SFAS No. 160 replaces the term minority interests with the newly-defined term of non-controlling interests and establishes this line item as an element of stockholders' equity, separate from the parent's equity. SFAS No. 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. The adoption of this standard did not have any material impact on condensed consolidated financial statements.

In June 2008, the FASB issued FASB Staff Position ("FSP") Emerging Issues Task Force ("EITF") No. 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." Under the FSP, unvested share-based payment awards that contain rights to receive non forfeitable dividends (whether paid or unpaid) are participating securities, and should be included in the two-class method of computing EPS. The FSP is effective for fiscal years beginning after December 15, 2008 and for interim periods within those years. The adoption of this standard did not have any material impact on condensed consolidated financial statements.

In November 2008, the FASB ratified EITF No. 08-6 "Equity Method Investment Accounting Considerations" which clarifies how to account for certain transactions involving equity method investments. The initial measurement, decreases in value and changes in the level of ownership of the equity method investment are addressed. EITF No. 08-6 is effective for the Company beginning on January 1, 2009, consistent with the effective dates of Statement 141R and Statement 160. EITF No. 08-6 will be applied prospectively. The adoption of EITF No. 08-6 did not have a material impact on the Company's condensed consolidated financial position and results of operations.

4. Revenue Recognition

Revenue is recognized net of discounts, rebates, promotional adjustments, price adjustments, returns and other potential adjustments upon shipment and passing of risk to the customer and when estimates of are reasonably determinable, collection is reasonably assured and the Company has no further performance obligations.

5. Inventories

Inventories consist principally of finished packaged foods, packaging and raw materials held in either the Company's manufacturing facility or distribution warehouse. Inventories are valued at cost determined using the first-in, first-out (FIFO) method.

6. Goodwill and Other Intangible Assets

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement No. 142 "Goodwill and Other Intangible Assets". This statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets". It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This Statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements.

In addition, the Company has acquired other intangible assets, which include: customer lists, trademarks, patents, and copyrights. The customer lists are being amortized over a period ranging between 5 and 7 years based on management's best estimate of the expected benefits to be consumed or otherwise used up. The costs of patents and copyrights are amortized over 5 and 7 years based on their estimated useful life, while trademarks representing brands with an infinite life, and are carried at cost and tested annually for impairment as outlined below. Goodwill and other intangible assets are tested annually for impairment in the fourth quarter, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. The Company assesses the recoverability of its goodwill and other intangible assets by comparing the projected undiscounted net cash flows associated with the related asset, over their remaining lives, in comparison to their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets.

	As of March 31, 2009		As of December 31, 2008	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization

Customer lists	$ 8,332,000	$ 5,014,000	$ 8,332,000	$ 4,649,000
Trademarks, patents, and copyrights				
finite life	1,640,000	745,000	1,640,000	685,000
infinite life	909,000	-	909,000	-
Total	$ 10,881,000	$ 5,759,000	$ 10,881,000	$ 5,334,000

Amortization expense for the three months ended March 31, 2009 and 2008 was as follows:

	2009	2008
Customer lists	$ 365,000	$ 402,000
Trademarks and patents	60,000	59,000
Total Trademarks and Intangibles	$ 425,000	$ 461,000

Amortization expense is included in selling, general and administrative expenses.

7. Fixed Assets

Fixed assets are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the related assets, which are generally three to seven years. Leasehold improvements and equipment under capital leases are amortized on a straight-line basis over the lesser of the estimated useful life of the asset or the related lease terms. Expenditures for repairs and maintenance are charged to expense as incurred, while major renewals and improvements are capitalized.

8. Note Receivable

Medifast realized a $1,503,000 note receivable as a result of the sale of Consumer Choice Systems on January 17, 2006 to a former board member. The note has a 10-year term with imputed interest of 4% collateralized by 50,000 shares of Medifast stock and all the assets of Consumer Choice Systems. The amount of principal to be collected over each of the next 5 years is $183,000 per year with the remaining amount collectible thereafter of $495,000.

9. Income Per Common Share

Basic income per share is calculated by dividing net income by the weighted average number of outstanding common shares during the year. Basic income per share excludes any dilutive effects of options, warrants and other stock-based compensation.

10. Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

11. Deferred Compensation Plans

We maintain a non-qualified deferred compensation plan for Senior Executive management. Currently, Bradley MacDonald is the only participant in the plan. Under the deferred compensation plan that became effective in 2003, executive officers of the Company may defer a portion of their salary and bonus (performance-based compensation) annually. A participant may elect to receive distributions of the accrued deferred compensation in a lump sum or in installments upon retirement

Each participating officer may request that the deferred amounts be allocated among several available investment options established and offered by the Company. These investment options provide market rates of return and are not subsidized by the Company. The benefit payable under the plan at any time to a participant following termination of employment is equal to the applicable deferred amounts, plus or minus any earnings or losses attributable to the investment of such deferred amounts. The Company has established a trust for the benefit of participants in the deferred compensation plan. Pursuant to the terms of the trust, as soon as possible after any deferred amounts have been withheld from a plan participant, the Company will contribute such deferred amounts to the trust to be held for the benefit of the participant in accordance with the terms of the plan and the trust.

Retirement payouts under the plan upon an executive officer's retirement from the Company are payable either in a lump-sum payment or in annual installments over a period of up to ten years. Upon death, disability or termination of employment, all amounts shall be paid in a lump-sum payment as soon as administratively feasible.

12. Fair Value Measurements

On January 1, 2008, the Company adopted SFAS No. 157 "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, provides a consistent framework for measuring fair value under Generally Accepted Accounting Principles and expands fair value financial statement disclosure requirements. SFAS 157's valuation techniques are based on observable and unobservable inputs. Observable inputs reflect readily obtainable data from independent sources, while unobservable inputs reflect our market assumptions. SFAS 157 classifies these inputs into the following hierarchy:

Level 1 Inputs– Quoted prices for identical instruments in active markets.

Level 2 Inputs– Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 Inputs– Instruments with primarily unobservable value drivers.

The following table represents the fair value hierarchy for those financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2009.

Fair Value Measurements on a Recurring Basis as of March 31, 2009

Assets	Level I	Level II	Level III	Total

Investment securities	$ 1,129,000	-	-	$ 1,129,000
Cash equivalents	6,300,000	-	-	6,300,000
Total Assets	$ 7,429,000	$ -	$ -	$ 7,429,000
Liabilities	-	-	-	-
Total Liabilities	$ -	$ -	$ -	$ -

Effective this quarter, we implemented Statement of Financial Accounting Standards No. 157, Fair Value Measurements, or SFAS 157, for our nonfinancial assets and liabilities that are remeasured at fair value on a non-recurring basis. The adoption of SFAS 157 for our nonfinancial assets and liabilities that are remeasured at fair value on a non-recurring basis did not impact our financial position or results of operations; however, could have an impact in future periods. In addition, we may have additional disclosure requirements in the event we complete an acquisition or incur impairment of our assets in future periods.

13. Share Based Payments

Stock-Based Compensation

Effective December 31, 2005, the Company adopted the provisions of Financial Accounting Standards Board Statement of Financial Accounting Standard ("SFAS") No. 123(R), "Share-Based Payments," which establishes the accounting for employee stock-based awards. Under the provisions of SFAS No.123(R), stock-based compensation is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the requisite employee service period (generally the vesting period of the grant). The Company adopted SFAS No. 123(R) using the modified prospective method and, as a result, periods prior to December 31, 2005 have not been restated. The Company recognized stock-based compensation for awards issued under the Company's stock option plans in other income/expenses included in the Condensed Consolidated Statement of Operations. Additionally, no modifications were made to outstanding stock options prior to the adoption of SFAS No. 123(R), and no cumulative adjustments were recorded in the Company's financial statements.

Unearned compensation represents shares issued to executives and Board members that will be vested over a 2-6 year period. These shares will be amortized over the vesting period in accordance with FASB 123(R). The expense related to the vesting of unearned compensation was $429,000 and $148,000 at March 31, 2009 and March 31, 2008, respectively. There was no expense related to vesting of options under FASB 123R at March 31, 2009 and 2008.

The following summarizes the stock option activity for the Three Months ended March 31, 2009:

	Shares	Weighted Average Exercise Price	Weighted Average Contractual Term (Years)
Outstanding, December 31, 2008	143,334	3.00	
Options granted			
Options reinstated			
Options exercised			
Options forfeited or expired			
Outstanding March 31, 2009	143,334	3.00	1.08
Options exercisable, March 31, 2009	143,334	3.00	1.08
Options available for grant at March 31, 2009	1,079,166		

14. Reclassifications

Certain amounts for the quarter ended March 31, 2008 have been reclassified to conform to the presentation of the March 31, 2009 amounts. The reclassifications have no effect on net income for the quarters ended March 31, 2009 and 2008.

15. Business Segments

Operating segments are components of an enterprise about which separate financial information is available that is regularly reviewed by the chief operating decision maker about how to allocate resources and in assessing performance. The Company has two reportable operating segments: Medifast and All Other. The Medifast reporting segment consists of the following distribution channels: Medifast Direct, Take Shape for Life, and Doctors. The All Other reporting segments consist of Hi-Energy, Medifast Weight Control Centers Corporate and Franchise, and the Company's parent company operations.

The accounting policies of the segments are the same as those of the Company. The presentation and allocation of assets, liabilities and results of operations may not reflect the actual economic costs of the segments as stand-alone businesses. If a different basis of allocation were utilized, the relative contributions of the segments might differ, but management believes that the relative trends in segments would likely not be impacted.

The following tables present segment information for the three months ended March 31, 2009 and 2008:

	Three Months Ended March 31, 2009			
	Medifast	All Other	Eliminations	Consolidated
Revenues, net	$ 30,734,000	$ 2,946,000		$ 33,680,000
Cost of Sales	7,369,000	685,000		8,054,000
Other Selling, General and Adminstrative Expenses	17,745,000	2,671,000		20,416,000
Depreciation and Amortization	990,000	239,000		1,229,000
Interest (net)	-	5,000		5,000
Provision for income taxes	1,491,000	-		1,491,000

Net income (loss)	$ 3,139,000	$ (654,000)		$ 2,485,000
Segment Assets	$ 35,575,000	$ 17,922,000		$ 53,497,000

	Three Months Ended March 31, 2008			
	Medifast	All Other	Eliminations	Consolidated
Revenues, net	$ 23,480,000	$ 1,689,000		$ 25,169,000
Cost of Sales	5,727,000	373,000		6,100,000
Other Selling, General and Adminstrative Expenses	14,246,000	1,646,000		15,892,000
Depreciation and Amortization	842,000	237,000		1,079,000
Interest (net)	10,000	55,000		65,000
Provision for income taxes	668,000	-		668,000
Net income (loss)	$ 1,987,000	$ (622,000)		$ 1,365,000
Segment Assets	$ 27,083,000	$ 18,973,000		$ 46,056,000

Management Discussion and Analysis of Financial Condition and Results of Operations

Except for the historical information contained herein, this Report on Form 10-Q contains certain forward-looking statements that involve substantial risks and uncertainties. When used in this Report, the words "anticipate," "believe," "estimate," "expect" and similar expressions, as they relate to Medifast, Inc. or its management, are intended to identify such forward-looking statements. The Company's actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. Accordingly, there is no assurance that the results in the forward-looking statements will be achieved.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles. Our significant accounting policies are described in Note 2 of the consolidated audited financial statements of our annual 10-K as of December 31, 2008.

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Management develops, and changes periodically, these estimates and assumptions based on historical experience and on various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Management considers the following accounting estimates to be the most critical in preparing our consolidated financial statements. These critical accounting estimates have been discussed with our audit committee.

Revenue Recognition. Revenue is recognized net of discounts, rebates, promotional adjustments, price adjustments, returns and other potential adjustments upon shipment and passing of risk to the customer and when estimates of are reasonably determinable, collection is reasonably assured and the Company has no further performance obligations.

Impairment of Fixed Assets and Intangible Assets. We continually assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. Judgments regarding the existence of impairment indicators are based on legal factors, market conditions and our operating performance. Future events could cause us to conclude that impairment indicators exist and the carrying values of fixed and intangible assets may be impaired. Any resulting impairment loss would be limited to the value of net fixed and intangible assets.

Income Taxes. In the preparation of consolidated financial statements, the Company estimates income taxes based on diverse legislative and regulatory structures that exist in jurisdictions where the company conducts business. Deferred income tax assets and liabilities represent tax benefits or obligations that arise from temporary differences due to differing treatment of certain items for accounting and income tax purposes. The Company evaluates deferred tax assets each period to ensure that estimated future taxable income will be sufficient in character amount and timing to result in their recovery. A valuation allowance is established when management determines that it is more likely than not that a deferred tax asset will not be realized to reduce the assets to their realizable value. Considerable judgments are required in establishing deferred tax valuation allowances and in assessing probable exposures related to tax matters. The Company's tax returns are subject to audit and local taxing authorities that could challenge the company's tax positions. The Company believes it records and/or discloses such potential tax liabilities as appropriate and has reasonably estimated its income tax liabilities and recoverable tax assets.

Allowance for doubtful accounts. In determining the adequacy of the allowance for doubtful accounts, we consider a number of factors including the aging of the receivable portfolio, customer payment trends, and financial condition of the customer, industry conditions and overall credibility of the customer. Actual amounts could differ significantly from our estimates.

General

Three Months Ended March 31, 2009 and March 31, 2008

Revenue: Revenue increased to $33.7 million in the first quarter of 2009 compared to $25.2 million in the first quarter of 2008, an increase of $8.5 million or 34%. The Take Shape for Life sales channel accounted for 56% of total revenue, direct marketing channel accounted for 33%, brick and mortar clinics 9%, and doctors 2%. Take Shape for Life sales, which are fueled by increased customer product sales as a result of an increase in active health coaches increased by 92% compared to the first quarter of 2008. As compared to the first quarter of 2008, the direct marketing sales channel, which is fueled primarily by consumer advertising, decreased revenues by approximately 13% year-over year, however, the advertising dollars spent were 17% less than the first quarter of 2008 as the Company continues to focus on more effective advertising spend. The Medifast Weight Control Centers increased sales by 72% due to the opening of new corporate and franchise locations.

Take Shape for Life revenue increased 92% to $18.9 million compared with $9.8 million in the comparable quarter of 2008. Growth in revenues for the segment were driven by increased customer product sales as a result of an increase in active health coaches. The number of active health coaches during the first quarter increased to approximately 4,000 compared with 2,200 during the period a year ago, an increase of 82% and up from 3,400 at the close of 2008. We continue to see the benefits of a physician-lead network of coaches that are able to support their clients in their weight-loss efforts. In today's environment where trust and personal recommendations are becoming a more important component in consumer purchasing decisions, the Take Shape for

Life model of one-on-one communication continues to excel. Take Shape for Life customers who have utilized the Medifast products and programs and successfully have addressed their body weight and health issues are increasingly choosing to become active health coaches. Becoming a health coach is a business opportunity that has a low cost of start-up and requires no holding of inventory as all orders are shipped to the end consumer. In the current economic environment, many people are looking for supplemental income to assist in paying the car payment or mortgage, and becoming a health coach allows for supplemental income in the form of a commission compensation on product sales and supporting the customer needs by providing education on the program and support to customers ordering through Take Shape for Life, and more importantly the ability to help others regain their health through the use of clinically proven Medifast products.

The Medifast Weight Control Centers, which represent approximately 9% of the Company's overall revenues, are currently operating in twenty one locations in Dallas, Houston, and Orlando. In the first quarter of 2009, the Company experienced revenue growth of 72% versus the same time period last year. The average monthly sales per clinic increased to $40,000 in the first quarter of 2009 compared to $39,000 a year ago. In the expanding Dallas, TX market, the average monthly revenue per clinic is approximately $50,000. In the second and third quarter of 2009, the Company plans on opening four to five additional corporately owned clinics in the Austin, TX market. The Company's Medifast Weight Control Center Franchise model has been expanding and now has ten centers in operation.

Overall, selling, general and administrative expenses increased by $4.6 million as compared to the first quarter of 2008. As a percentage of sales, selling, general and administrative expenses decreased to 64.2% versus 67.6% in the first quarter of 2008, which lead to a 70% increase in diluted earnings per share in the first quarter of 2009 versus prior year. Take Shape for Life commission expense, which is completely variable based upon revenue, increased by approximately $3,800,000 as the Company showed sales growth of 92% as compared to the first quarter of 2008. Salaries and benefits increased by approximately $700,000 in the first quarter of 2009 as compared to last year. The increase includes the hiring of additional expertise in critical areas such as Take Shape for Life and the Medifast Weight Control Centers in the second half of 2008 which have greatly impacted revenue growth in 2009. In addition, the opening of eight new corporately owned clinics in the Houston, TX market and two in the Dallas, TX market also required the hiring of additional center managers and support staff. Advertising expense for the first quarter of 2009 was approximately $4.3 million compared to approximately $5.2 million for the same period last year, a decrease of $900,000 or 17%. Communication expense, decreased by $100,000 as the outsourced Take Shape for Life call center was brought in-house early in the second quarter of 2008. Other expenses increased by $500,000 which included items such as depreciation, amortization, credit card processing fees, charitable contributions, and property taxes. Operating expenses increased by $250,000 which primarily resulted from additional printing expense for our direct to consumer postcard mailings as well as maintenance, repairs, and supplies for our manufacturing and distribution facilities. Office expense increased by $100,000 and stock compensation expense increased by $282,000 as additional restricted shares were issued to key executives and Board members in the third and fourth quarters of 2008 that will be vesting over a five year term.

Costs and Expenses: Cost of revenue increased $2 million to $8.1 million in the first quarter of 2009 from $6.1 million in the first quarter of 2008. As a percentage of sales, gross margin increased to 76.1% from 75.8% in the first quarter of 2008. The margin improved slightly due to the addition of efficient new machinery and process improvements achieved in our vertically integrated business model.

Income taxes: In the first quarter of 2009, the Company recorded $1,491,000 in income tax expense, which represents an annual effective rate of 37.5%. The tax rate increased due to an increase in the Maryland state income tax rate as well as timing differences on amortization expense on our intangible assets between book and tax financials that increased our tax expense in 2009. In the first quarter of 2008, we recorded income tax expense of $668,000 which reflected an estimated annual effective tax rate of 32.9%. The Company anticipates a tax rate of approximately 36-38% in 2009.

Net income: Net income was approximately $2.5 million in the first quarter of 2009 as compared to approximately $1.4 million in the first quarter of 2008, an increase of 82%. Pre-tax profit as a percent of sales increased to 11.8% in the first quarter of 2009 as compared to 8.1% in 2008. The improved profitability in the first quarter of 2009 is due to sales growth in the Take Shape for Life division and Medifast Weight Control Centers as well as improved advertising effectiveness in the Medifast Direct Marketing sales channel, gross margin improvement as well as leveraging the fixed costs associated with our vertically-integrated support structure.

SEGMENT RESULTS OF OPERATIONS

Net Sales by Segment as of March 31,

Segments	2009 Sales	2009 % of Total	2008 Sales	2008 % of Total
Medifast	30,734,000	91%	23,480,000	93%
All Other	2,946,000	9%	1,689,000	7%
Total Sales	33,680,000	100%	25,169,000	100%

Three Months Ended March 31, 2009 and March 31, 2008

Medifast Segment: The Medifast reporting segment consists of the sales of Medifast Direct, Take Shape for Life, and Doctors. As this represents the majority of our business this is referenced to the "Condensed Consolidated Results of Operations" management discussion for the three months ended March 31, 2009 and 2008 above.

All Other Segment: The All Other reporting segment consists of the sales of Hi-Energy, Medifast Weight Control Centers and Medifast Weight Control Franchise Centers. Sales increased by $1,257,000 year-over year for the three month period ended March 31, 2009. Sales increased in the Hi-Energy, Medifast Weight Control Centers, and Franchise Centers due to the opening of ten new corporate centers in 2008 and new franchise centers at the end of 2008 and first quarter of 2009. In addition, the Dallas market continues to mature with the average clinic generating $50,000 per month in sales. The Company is continuing to focus on improved advertising effectiveness, improved closing rates on walk-in sales, as well as the hiring of more experienced clinic operators to manage the clinics, and improved efficiencies in operation of the clinics. The Company now has twenty one corporately owned clinics, compared to ten clinics in operation at the end of the first quarter of 2008. The Company also has ten franchisee centers in operation.

Net Profit by Segment for the Three Months Ended March 31,

Segments	2009 Profit	2009 % of Total	2008 Profit	2008 % of Total
Medifast	$ 3,139,000	126%	$ 1,987,000	146%
All Other	(654,000)	-26%	(622,000)	-46%
Total Net Profit	$ 2,485,000	100%	$ 1,365,000	100%

Three Months Ended March 31, 2009 and March 31, 2008

Medifast Segment: The Medifast reporting segment consists of the profits of Medifast Direct, Take Shape for Life, and Doctors. As this represents the majority of our business this is referenced to the "Condensed Consolidated Results of Operations" management discussion for the three months ended March 31, 2009 and 2008 above. See footnote 15, "Business Segments" for a detailed breakout of expenses.

All Other Segment: The All Other reporting segment consists of the profit or loss of Hi-Energy and Medifast Weight Control Centers, Medifast Weight Control Franchise Centers, and corporate expenses related to the parent company operations. Year-over-year, the loss in the All Other segment increased by $32,000. The Hi-Energy, Medifast Weight Control Centers, and Franchise Centers showed an increase in net profitability year-over-year of $219,000. The increase in profitability was due to opening of ten new corporately owned centers in 2008 and new franchise centers at the end of 2008 and early 2009. The increase in the total number of corporate clinics to twenty one and ten operating franchise centers led to additional sales and profitability. Medifast Corporate expenses increased by $251,000 year-over-year. Corporate expenses include items such as auditors' fees, attorney's fees and corporate governance related to NYSE, Sarbanes Oxley, and SEC regulations. See footnote 15, "Business Segments" for a detailed breakout of expenses.

Seasonality

The Company's weight management products and programs have historically been subject to seasonality. Traditionally the holiday season in November/December of each year is considered poor for diet control products and services. January and February generally show increases in sales, as these months are considered the commencement of the "diet season." In 2009, seasonality has not been a significant factor. This is largely due to the increase in the consumer's awareness of the overall health and nutritional benefits accompanied with the use of the Company's product line. As consumers continue to increase their association of nutritional weight loss programs with overall health, seasonality will continue to decrease.

Inflation

Inflation generally affects us by increasing the costs of labor, overhead, and raw material and packaging costs. The impact of inflation on our financial position and results of operations was minimal during the first quarter of 2009.

Item 5. Other Information

Litigation:

There is no pending or threatened litigation.

Other Matters:
An Independent Committee of the Board of Directors of Medifast was constituted to review the public allegations of a third party "Convicted Felon" on his website pertaining to alleged illegal activities of Take Shape for Life, a Direct Selling Subsidiary of Medifast Inc. Other public Direct Selling Companies have been attacked by this individual and his network of associates using the same blueprint of allegations. These public allegations were made in mid-February and were immediately followed by significant short selling and short selling option puts that shaved over $30 million from the Market Capitalization of Medifast. The company has demanded that this third party take down its website information containing false information or be subject to appropriate legal action.

Medifast, in a press release on February 17th, 2009, responded to the False Claims in SEC File # 001-31573; Film #09617581. The Independent Committee appointed Chairman Mr. Barry B. Bondroff, CPA, an officer and director with Gorfine, Schiller & Gardyn, PA. Members are: Mr. George J. Lavin Esq, founding Partner of the law firm, Lavin, O'Neil, Ricci, Ceprone & Dispicio, who is an expert in Product Liability Law, Lt. Gen. Dennis M. McCarthy USMC (Ret.), Executive Director of the Reserve Officers Association of the United States and a licensed attorney, Capt. Joseph D. Calderone USNR (Ret.), chaplain and counselor of the Villanova University Law School, and Mr. Charles P. Connolly, former President and CEO of First Union Corp of PA and DE .

After an investigation of the facts and information developed to date the committee unanimously agreed that the allegations were false, misleading and or without merit.

Counsel forwarded 3 cease and desist demands by letter to Barry Minkow , a convicted felon, and FDI, of which Minkow/FDI confirmed receiving two. In addition, the Company has filed formal complaints with the NYSE, SEC, and ATTORNEY GENERAL OF MARYLAND to this time. Management as directed by the Board continues to monitor the situation and will continue to take appropriate action as it deems necessary.

Earnings per Share: The Company follows the provisions of Statement of Financial Accounting Standards No. 128, "Earnings per Share." The calculation of basic and diluted earnings per share ("EPS") is reflected on the accompanying Condensed Consolidated Statement of Income.

Code of Ethics: In August of 2006, the Company updated its Code of Ethics by which directors, officers and employees commit and undertake to personal and corporate growth, dedicate themselves to excellence, integrity and responsiveness to the marketplace, and work together to enhance the value of the Company for the shareholders, vendors, and customers.

Trading Policy: In March 2003, the Company implemented a Trading Policy whereby if a director, officer or employee has material non-public information relating to the Company, neither that person nor any related person may buy or sell securities of the Company or engage in any other action to take advantage of, or pass on to others, that information. Additionally, on October 16, 2006 the Board of Directors approved an updated trading policy in which insiders may purchase or sell MED securities if such purchase or sale is made 7 days after or 14 days before an earnings announcement to include the 10-K or 10-Q in order to insure that investors have available the same information necessary to make investment decisions as insiders.

Evaluation of Disclosure Controls and Procedures:

The Securities and Exchange Commission defines the term "disclosure controls and procedures" to mean a company's controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Based on the evaluation of the effectiveness of our disclosure controls and procedures by our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, as of the end of the period covered by this report, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures at the end of the period covered by this report were effective to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

Changes in Internal Control over Financial Reporting:

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended March 31, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Forward Looking Statements: Some of the information presented in this quarterly report constitutes forward-looking statements within the meaning of the private Securities Litigation Reform Act of 1995. Statements that are not historical facts, including statements about management's expectations for fiscal year 2003 and beyond, are forward-looking statements and involve various risks and uncertainties. Although the Company believes that its expectations are based on reasonable assumptions within the bounds of its knowledge, there can be no assurance that actual results will not differ materially from the Company's expectations. The Company cautions investors not to place undue reliance on forward-looking statements which speak only to management's experience on this data.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Medifast, Inc.

BY: /S/ MICHAEL S. MCDEVITT May 8, 2009
Michael S. McDevitt
Chief Executive Officer and Chief Financial Officer
(principal executive officer and principal financial officer)

Index to Exhibits

Exhibit Number	Description of Exhibit
31.1	Certification of Chief Executive Officer pursuant to Item 601(b)(31) of Regulation S-K, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Item 601(b)(31) of Regulation S-K, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 31.1

RULE 13a-14(a) CERTIFICATION

I, Michael S. McDevitt, certify that:

1. I have reviewed this report on Form 10-Q of Medifast, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 8, 2009

/s/ Michael S. McDevitt
Michael S. McDevitt
Chief Executive Officer, Chief Financial Officer

Exhibit 31.2

RULE 13a-14(a) CERTIFICATION

I, Michael S. McDevitt, certify that:

1. I have reviewed this report on Form 10-Q of Medifast, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 8, 2009

/s/ Michael S. McDevitt
Chief Financial Officer

Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Medifast, Inc. (the "Company") on Form 10-Q for the quarter ended March 31, 2009, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael S. McDevitt, Chief Executive Officer and Chief Financial Officer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the report fairly presents, in all material respects, the financial condition and results of the operations of the Company.

By: /s/ Michael S. McDevitt
Michael S. McDevitt
Chief Executive Officer, Chief Financial Officer
May 8, 2009

9th Circuit Case Number(s) 11-55687, 11-55699

NOTE: To secure your input, you should print the filled-in form to PDF (File > Print > *PDF Printer/Creator*).

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CERTIFICATE OF SERVICE
When All Case Participants are Registered for the Appellate CM/ECF System

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on (date) 5/11/2012 .

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

Signature (use "s/" format) s/ John H. Stephens

****

CERTIFICATE OF SERVICE
When Not All Case Participants are Registered for the Appellate CM/ECF System

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on (date) .

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

I further certify that some of the participants in the case are not registered CM/ECF users. I have mailed the foregoing document by First-Class Mail, postage prepaid, or have dispatched it to a third party commercial carrier for delivery within 3 calendar days to the following non-CM/ECF participants:

Signature (use "s/" format)