GIBSON DUNN

Gibson, Dunn & Crutcher LLP

2100 McKinney Avenue
Dallas, TX 75201-6912
Tel 214.698.3100
www.gibsondunn.com

James C. Ho
Direct: +1 214.698.3264
Fax: +1 214.571.2917
JHo@gibsondunn.com

February 9, 2015

Lyle W. Cayce, Clerk
U.S. Court of Appeals for the Fifth Circuit
600 S. Maestri Place
New Orleans, LA 70130

Re: *Torres* v. *S.G.E. Management, L.L.C.*, No. 14-20128

Dear Mr. Cayce:

The panel in this case has asked the parties to file a four-page post-argument letter. Defendants request that this letter be circulated to the members of the panel.

In the typical fraud case, reliance is an individualized issue, not a common issue, because it concerns each class member's state of mind. Those cases are not subject to class certification. There are circumstances, however, where reliance can be a common issue. In those cases, class members receive a common misrepresentation, they respond by taking the same action, and that common response can support a classwide inference of reliance—***if*** reliance on the misrepresentation is the only possible explanation for the class members' decision.

The common misrepresentation alleged by Plaintiffs in this case is that Stream Energy is a pyramid scheme. To certify this class, Plaintiffs must prove that the only explanation for a decision to become an IA is reliance on the belief that Stream Energy is not a pyramid scheme. But if class members could have decided to become an IA regardless of that alleged misrepresentation—*e.g.*, because they reasonably believed that they could make money—then reliance on the alleged misrepresentation is not the only possible explanation for the decision to become an IA—and the classwide inference of reliance fails.

1. The parties agree that, at the class certification stage, the Court does not consider the merits of Plaintiffs' allegation that Stream Energy is a pyramid scheme. *See, e.g.*, Pltfs' Br. 11 n.3. The issue at this stage is whether reliance can be proven with common or individualized evidence. But make no mistake: Stream Energy is not an illegal pyramid scheme.

The facts reflect that Stream Energy is a legitimate program in which IAs possessed a very real prospect of making money. Stream Energy sells a real

product: energy. Over 97% of its revenue comes from energy sales—*billions* of dollars of energy, sold to over a *million* customers who are not IAs. Doc. No. 129, Ex. 1 ¶¶ 10-11 (Sealed Affidavit). Ten years into the business, it is now one of the largest energy retailers in Texas. Yet it has just 5% market penetration, leaving plenty of room for further growth. And neither the FTC nor any state authority has ever taken action against Stream Energy's IA marketing structure.

The ***only*** way an IA can receive any compensation is to sell energy to customers. Stream Energy pays ***zero*** compensation solely for recruiting. Doc. No. 129, Ex. 2 ¶ 89 ("Recruitment without sales earns an IA a zero commission."). IAs receive monthly energy income (MEI) only after a customer pays for energy service. *Id.* And IAs are not required to purchase any inventory themselves.

During oral argument, Plaintiffs claimed that, of the $54 million paid to IAs in 2012, most of it covered "recruiting incentives," not customer sales. It is unclear where Plaintiffs derive that number—but, in any event, every penny paid to IAs requires the sale of energy to customers. Stream Energy does pay commissions to an IA for sales generated by that IA's recruit, but that is consistent with standard industry practice, which encourages associates to grow their sales forces. The benefit of leverage is familiar to every business in America: The more people you have working for you, the more productive your business will be.

Stream Energy's financial statements, audited by Ernst & Young, confirm the legitimacy of its business. Doc. No. 129, Ex. 1(A-G). Here is a summary:

Financial Information From Financial Statements Audited by Ernst & Young, LLP						
	2008	**2009**	**2010**	**2011**	**2012**	***% of Revenue***
Energy Revenues	800,723,000	829,091,000	825,104,000	828,947,000	814,352,000	***97.49%***
Energy Gross Profit	56,194,000	146,573,000	166,256,000	130,501,000	125,248,000	
IA Revenues	23,000,000	17,500,000	17,900,000	26,900,000	20,200,000	***2.51%***
IA Sales Commissions	(38,300,000)	(34,800,000)	(36,300,000)	(50,000,000)	(42,500,000)	
IA Program, Net	(15,300,000)	(17,300,000)	(18,400,000)	(23,100,000)	(22,300,000)	
Other Expenses	(43,389,000)	(57,178,000)	(99,349,000)	(98,086,000)	(92,807,000)	
Income From Operations	**(2,495,000)**	**72,095,000**	**48,507,000**	**9,315,000**	**10,141,000**	

2. Turning to the merits of this appeal: According to Plaintiffs, a class action should be certified in this case simply because they have alleged that Stream Energy is a pyramid scheme—and ***regardless*** of whether class members have a reasonable prospect to make money. At oral argument, Plaintiffs offered two rationales to support this novel theory of class certification.

First, they argued that people would not join any pyramid scheme, because there are only two possible outcomes—either an enrollee will lose money, or will make money based on losses to others. It is telling that they must include this second outcome ("losses to others") in their rationale. They appear to recognize that people rightfully thought they could make money by joining Stream Energy. So they need their "losses to others" theory to certify this massive class. But Plaintiffs supply no authority (and there is none) for the utterly naive proposition that every class member would decline an opportunity to benefit themselves, simply because it may cause others down the road to lose some money.

Second, Plaintiffs argued that people would not engage in illegal activity to make money. This too is not right. Consider the hypothetical presented during oral argument: Plenty of people are willing to accept the business opportunity of selling "knockoff" designer handbags, even though it is illegal to do so.

The question in this case, of course, is not whether people *should* do these things—but rather, whether people *do* do these things. In particular, the question is whether courts should certify class actions that are premised on ignoring that distinction—and allowing such people to sue as RICO plaintiffs. The fact that people choose to avail themselves of such business opportunities is fatal to Plaintiffs' rationale for a classwide presumption of reliance.

3. Thus, this class can be certified only if Plaintiffs prove that the class members had no reasonable prospect of making money. *See, e.g.*, Defts' Br. 16-18 (collecting cases); Reply Br. 6-7 (same); Defts' 28(j) letter (same). Plaintiffs have the burden to meet this standard. They did not—and cannot—which presumably explains why they do not even bother to invoke this theory of class certification.

To the contrary, according to Plaintiffs' own data, 14% of IAs have made a profit—that is, 29,155 IAs who joined during this class period. Doc. No. 123, App. III, Ex.1(a), Schedule 1 (Sealed Expert Report). The percentage doubles to over 29%, or 59,672 IAs, if you exclude website costs—which IAs are not required to pay if they wish to market their business without a website, and can cancel at any time if they decide the business is not for them.[1]

[1] Incidentally, of the 29,155 IAs who joined during this class period and made a profit, a significant number made a *substantial* profit. According to Plaintiffs' own data, 9,426 IAs made over $1,000 in profit (an over 300% return on their $329 fee), 618 IAs made over $50,000 in profit, and 268 IAs made over $100,000 in profit. (These numbers are comparable to, if not better than, some of the biggest names in the direct sales industry.)

This data alone is enough to show that class members had a reasonable prospect to make money. Class members are similarly situated to, and had the same opportunity to make money as, fellow IAs who joined at the same time and *did* make money. Plaintiffs do not argue (and present no evidence) to the contrary.

Moreover, these opportunities were not limited to people early in the class period. IAs who joined in each and every year covered by the class period (from January 1, 2005 to April 2, 2011) enjoyed a very real prospect to make money:

Year	New IAs	Excluding Optional Website Costs		Including Optional Website Costs	
		# of Those New IAs Who Profited	% of Those New IAs Who Profited	# of Those New IAs Who Profited	% of Those New IAs Who Profited
2005	21,689	6,149	28.35%	3,515	16.21%
2006	36,434	10,586	29.06%	5,335	14.64%
2007	36,751	10,288	27.99%	4,835	13.16%
2008	39,986	11,274	28.19%	5,295	13.24%
2009	23,500	6,210	26.43%	2,759	11.74%
2010	29,764	8,767	29.46%	4,493	15.10%
2011	19,535	6,398	32.75%	2,923	14.96%
Total	**208,856**	**59,672**	**28.74%**	**29,155**	**14.04%**

In sum, class members had a reasonable prospect to make money throughout the class period. To be sure, some IAs made money while others did not—just as some small businesses make money while others do not. It is no wonder, then, that Plaintiffs do not seek certification on the ground that class members could not have rightfully thought that they could make money. *See also* ROA.2265 (district court opinion) ("class members . . . became IAs . . . because they believed they (though not necessarily everyone else) would make a significant amount of money, even if not as much as advertised").[2]

The Court should reverse the certification order and remand for trial on the merits of Plaintiffs' claims. Alternatively, if the Court wishes to give Plaintiffs another chance, the Court could vacate the certification order with instructions that, if Plaintiffs wish to move to recertify the class, they must prove that class members did not believe they had a reasonable prospect to make money.

[2] These success rates might actually be understated. 10% of IAs who did not make a profit did not bother to sign up even a single energy account—meaning they did not even bother to sign *themselves* up as an energy customer, the most basic step in seriously pursuing this business opportunity. For example, if Plaintiff Robison had bothered to sign up just two customers (*e.g.*, himself and one other), he would have made back his sign-up fee—and this suit would no longer have a class representative. Indeed, that's why Plaintiff Torres is no longer a class representative: he made money. Doc. No. 129, Ex. 4, ¶ 25 ("Torres earned more money from Ignite than he paid in fees to Ignite, even if optional homesite fees are included.").

Respectfully,

/s/ *James C. Ho*

James C. Ho
GIBSON, DUNN & CRUTCHER LLP
2100 McKinney Avenue, Suite 1100
Dallas, TX 75201-6912
Tel.: (214) 698-3264
Fax: (214) 571-2917
jho@gibsondunn.com

COUNSEL FOR APPELLANTS

CERTIFICATE OF SERVICE

I hereby certify that, on February 9, 2015, a true and correct copy of the foregoing letter was served via the Court's CM/ECF system on all counsel of record for all parties.

/s/ James C. Ho
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