Vemma Preliminary Injunction Order… First Take

Time for the Industry and Vemma to Press the Reset Button

Jeffrey A. Babener

It's the End of the World As We Know It - **REM**

Well, actually... maybe not.

The direct selling industry is pondering the impact of the September 18, 2015 Preliminary Injunction Order in *FTC v. Vemma*.

It will have a major influence on direct selling, but perhaps more on business practices than legal standards.

What Happened?

On August 17, 2015, the FTC filed a complaint in U.S. District Court in Arizona seeking a permanent injunction against Tempe-based Vemma International Holdings, Inc., a long-time direct selling marketer of health-related products. The FTC was successful in obtaining a temporary restraining order, which shut the company, froze its assets and placed it under the control of a court- appointed receiver.

A follow-up hearing on a preliminary injunction was held, and one month later, on September 18, 2015, the Court entered a preliminary injunction. In its Order, the Court found that there was substantial likelihood that, at trial, Vemma would be found to have operated a pyramid scheme:

1. due to its promotional and operational practices that pushed recruits to buy starter packages and subscribe to autoship in order to qualify for commissions,

2. and, secondly that it engaged in deceptive practices relating to overt or inferred promises of substantial earnings that did not materialize for most participants.

Nevertheless, the Court recognized that there was consumer demand for the product and a rationale for allowing the business to continue, to serve its customers and attempt to operate a viable and compliant business operation. And thus, the Court removed the receiver, unfroze the assets, and allowed the company to reopen during the pendency of trial, but under significant restraints and under the watch of a federal monitor.

Specifically, the Court adopted, what is referred to in this FTC area of law as "fencing in" language. The Court's order prohibited tying qualification for commissions to affiliate

purchases of product packages or autoship, and also prohibited paying commissions unless the majority of product sold was sold to nonparticipant retail customers.

The industry was left to ponder the meaning of the "fencing in" order and its ramifications for the entire direct selling industry.

The Fencing In Language is Specific to Vemma

It would appear that the fencing in language is specific to Vemma as a penalty for past abuse. The Order is an Order. It is not case law and is not case precedent. Actually, if the Order were suggested to be precedent, it would not be consistent with case law or the landmark 9th Circuit Appeals Court pyramid case rulings in *Koscot* or *BurnLounge*. The *BurnLounge* ruling, following on *Koscot*, requires emphasis on sales to ultimate users, which includes nonparticipant retail customers and personal use in reasonable amounts. Primary motivation for distributor purchases should be destination to ultimate users and not to qualify in the plan for compensation.

Effectively, the Court said that Vemma spent so much time telling people they "must buy" that the Court inferred that recruits' primary intent was to qualify (rather than buy for resale or personal use) because that is what they were told to do by the company.

In the absence of a concerted marketing system that pushed "qualification," the Court recognized personal use as a sale to an ultimate user.

However, the Court ruled that the systematic "pushing" of purchases for qualification renders those purchases as ***incidental to the business opportunity as opposed to intent for resale/personal use for an ultimate user … disqualifying the sales as being sales to ultimate users.***

The net result, opined the Court, was that Vemma forfeited its right to rely on personal use for qualification and commission purposes.

This is a big message to all companies, i.e., get your act together on how you promote your product and opportunity.

It is a mixed decision.

The old approach was problematic, but product was recognized as real. And so, the court continued the injunction to allow the business to continue, but under severe restraints.

The business will be allowed to continue in possession of the owners, not a receiver, but under view of a "monitor" with restrictions to avoid old offensive behavior.

The one major problem that renders Vemma less competitive among other consumables direct sellers:

Paragraph 4 of the Order only allows compensation if sales are greater than 50% to nonparticipants. This paragraph is not only ambiguous and hard to understand (is this per rep or for the entire program?) and is inconsistent with 9th Circuit case authority in *Koscot* and *BurnLounge*, which merely prohibits compensation unless paid on sales to "ultimate users"…. and, in which ultimate users are recognized as nonparticipants and distributors who purchase for personal use in reasonable amounts.

One possible interpretation of Paragraph 4:

If a rep has volume, compensation for the reps' personal or group volume, compensation cannot exceed 49 percent of the personal or group volume for sales to the rep or his downline … i.e., the company can pay commissions on personal use or inventory sales volume, up to 49% of the total volume.

Effectively, personal use is counted as a half sale ... which is at variance with every other direct selling company.

Again, this result is not consistent with *Koscot* or *BurnLounge*.

The District of Arizona is in the 9th Circuit and bound by case authority. Since the matter before the Court is fashioning a preliminary injunction order which balances the harms to the parties, rather than entering a formal ruling in the case, the Court designed an interim order with "fencing in" language specific to this defendant and the circumstances pending a formal trial on the merits. It split the baby… kind of ...

It would appear that the Court is not saying paragraph 4 is precedent or the standard, but that it is an appropriate price to pay for allowing the business to go forward, in light of Vemma's practices which tainted the market and left the wrong impression with reps as to why they should buy ... i.e., some relief here, but no free pass … ***the auto is allowed on to the turnpike, but its speed restricted to 40 miles per hour***. In a way, the restriction is not unlike lifestyle restrictions that Courts place on individuals who are on probation or parole … no drinking, be home by 9 p.m., don't travel, etc. … restrictions that impair normal living, but which are the price to pay … i.e., freedom is curtailed. Here normal operating business practices are curtailed.

How is this Case Different than *BurnLounge*?

The fact that the Court allowed continued operation of the business suggested that it differentiated *Vemma* facts from *BurnLounge* facts. And, it is true ... the facts here are not *BurnLounge* facts.

This case is distinguishable from *BurnLounge* in which commissions were paid on primary revenue from sale of web-hosting sites, which the Court found were sales tools and not consumer products … although some product was added to the bundle. The

Court found that distributors were really paying for a bundled opportunity and that the web portal purchase was a gateway to participate in the comp plan.

Similarly, although real consumer products were sold in *Vemma*, the company's promotional materials which focused on purchasing, qualifying and recruiting, rendered the sales into the category of primarily purchasing a bundled opportunity for qualification in the plan rather than purchasing for use by the ultimate user, i.e., for resale or personal use. And, thus, Vemma was penalized for its historical promotional emphasis on purchase for qualification.

In a different, but parallel fashion, the courts concluded in both *BurnLounge* and *Vemma* that purchases were incidental to the opportunity.

But, because Vemma was selling consumer products and not sales tools, some redemption was possible, albeit requiring Vemma to market in a fashion that is not competitive with the rest of the industry and in a restricted approach not consistent with the state of the law on personal use.

It is possible that Vemma will ask for a rehearing on this issue and may seek an interlocutory appeal on this issue. It will not likely get relief, at least in the immediate future.

After a period of time of demonstrated "good behavior," the court might reconsider this "hamstring."

The message: Actions have consequences. As Collin Powell said in his Pottery Barn metaphor, "If you break it, you own it."

No other direct selling company operates this way and it is also inconsistent with the 2004 FTC Staff Advisory.

It is clear the court is fashioning the order more strictly in response to past abuse. As Marsellus Wallace noted to Butch in Pulp Fiction: "You've lost your LA privileges." Will other direct selling companies change their rules on credit for personal use? Probably not. However, they will certainly pay close attention to the activities that could cause them to lose the right to claim credit for personal use.

The Direct Selling Industry Should Press the Reset Button

There are at least three clear "to do" messages for direct selling companies:

1. Monitor Communication.

Every direct selling company should take this opportunity to carefully vet company and distributor public discussions and presentations to assure that the focus and emphasis is on teaching a program whose purpose is to create a

customer base and not a "system" of finding recruits who purchase, who find other recruits who purchase … i.e., rewards for sales to ultimate users rather than recruitment of distributors to buy and recruit.

Purchase for resale or personal use: Yes. Purchase to qualify: No.

2. **Track Product Movement.**

Track product to its final destination. The bottom line is that companies should be able to document that product makes its way on to "ultimate users" and is used.

3. Determine Reasonable Ordering Needs

Companies need to take a close look at the needs of novice and experienced distributors to determine what are "reasonable needs" requirements.

This task may entail extensive user studies, focus groups and the creation of objective criteria to determine that the ordering patterns of distributors, new or experienced, is matched to "reasonable needs" and not merely to qualifying in the plan.

And Vemma Should Press the Reset Button

If Las Vegas oddsmakers were accepting bets, the winning wager might be, based on a long line of FTC cases, that this case will not go to trial, but will settle with a Stipulated Permanent Injunction Order in which the FTC, Vemma and the Court agree to address restitution and penalties to those previous consumers alleged to be victims, and secondly, to adopt a going forward framework of business practices relating to pyramiding and deceptive earnings claims issues that are a compromise on compliance. It is highly unlikely that Vemma will ever be able to operate with the complete competitive freedom of the rest of the industry … i.e., some type of ***fencing in*** restrictions will appear in either a Stipulated Permanent Injunction Order or an Adjudicated Permanent Injunction Order.

In the meantime, Vemma should make the most of this chance at a new life and for redemption in the eyes of the Court. For a month there, it was "dead" … and this glass is half full, not half empty … the Preliminary Injunction Ruling is its "defibrillator."

At a minimum, Vemma should press the reset button on its relationship with customers and distributors.

Perhaps, it should use this opportunity to start from scratch and enter into new agreements, one strictly for customers or preferred customers (those that wish to commit to autoship). And, one for affiliates. A preferred customer would have one right only: to purchase product, and, perhaps at a discount, if on autoship. And, affiliates

would have only one right: to help gather customers and to build a sales organization. An affiliate could also sign on separately as a preferred customer for personal use or, with proper "vetting" of demonstration of "need" and verification of resales, purchase product for resale.

Under the prior program, where there was no charge to sign on as an affiliate, the identity of the consumer and affiliate became blurred. This often happens to companies that adopt this approach, and for this reason, it is not a "best business" practice. Perhaps, it is better to differentiate and identify those that wish to be affiliates by charging an affiliate "at cost" starter kit fee (sales kit or online marketing support), typical in the industry of $49, along with a modest monthly administrative fee for replicated website, back office and communication tools. Obviously, there is no charge to merely be a customer or preferred customer. Those who wish to pursue the business opportunity will affirmatively need to pay starter kit and administrative fees. Such fees would make no sense to individuals who merely wish to buy product for personal use. This approach is the long practiced approach by leading direct selling companies.

Obviously, there are many ways to address the "differentiation issue." But, one thing is clear … it is mandatory for Vemma to keep track of sales to nonparticipants and sales to those who are participants. Under the new rules of engagement, failure to track and demonstrate that the majority of sales are to nonparticipants, means no payment of commissions to the affiliate who produces the sales volume.

And of course, obviously, pushing the Reset Button here means thoroughly vetting the promotional practices of the company and its distributors to ensure that the theme is "customer acquisition" and not "distributor purchasing for qualification."

Swinging the Pendulum to the Center

It is often said that a pendulum swings far to the left and far to the right, but sooner or later returns to the middle. Perhaps, in reinventing itself, with an emphasis on promoting sale of product to actual customers, Vemma's pendulum will swing successfully to the center.

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