Fact Checking the FTC's New Legal Guidance

By Jeff Babener, © 2017
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Sir, you are entitled to your own opinion. You are not entitled to your own facts.
- Senator/Ambassador Daniel Moynihan

Shifting Sands

In her first post-***FTC v. Herbalife*** settlement presentation, FTC Chairwoman Edith Ramirez argued that it was time to ratchet up regulation of the direct selling industry, and not a time to "put the brakes" on more regulation of the $36 billion industry and its 20 million strong sales force.

It was clear that the FTC and the Direct Selling industry are on the same wavelength as to a basic goal that the direct selling industry should prosper through effective and ethical practices. But, there remains a respectful divergence on methodology. During her well-articulated speech to the October, 2016 DSA

Policy Conference, she enunciated a wish list for new legal standards that would abandon a 40-year old gold standard, the ***Amway Safeguards Rule,*** and that would also upend and call into question decades of industry accepted business practices.

The Chairwoman argued for:

1. Abandonment of reliance on the ***Amway Safeguards Rule*** as a key test for legitimacy.

2. Effectively creating a new legal standard patterned after those ***requested by the FTC*** in the ***FTC/Herbalife*** settlement that, in reality, may upend decades of industry accepted practices and rewrite 40 years of court legal standards.

The existing Court standard derives from:

(1) ***Koscot*** … Compensation to upline should be based on sales to the ***ultimate user***.

(2) ***Amway*** … A program that enforces the ***Amway Safeguards*** of a retailing mandate to qualify for MLM commissions, a 70% rule that prohibits ordering unless product is sold or used and a reasonable buyback policy for inventory for terminating distributors, if effectively enforced and in conjunction with avoidance of inventory loading, is indicative of legitimacy. (Also, ***Amway*** did not challenge recognition of

distributor personal use purchases as legitimate sales to the "ultimate user".)

(3) ***BurnLounge*** … The ***primary motivation*** for distributor purchases should be the purchase of product in reasonable amounts for resale or use as opposed to mere qualification in the program for rewards. A pyramid analysis will be "fact driven."

On the FTC wish list for a new paradigm for legitimacy is:

(1) Abandonment of the reliance on the ***Amway*** standard.

(2) Redefining ***Koscot*** to require compensation to upline to be based on sales to the ***nonparticipant retail customer*** rather than the ***ultimate user***.

(3) Adopting the ***FTC/Herbalife*** settlement "punch list" of mandates in lieu of the factual analysis of "primary motivation," called for in ***BurnLounge***, including:

(a) Only one-third of MLM compensation to upline should come from personal use by downline distributors, whether or not such purchases are reasonable in quantity for use by the distributor "ultimate user."

(b) Autoship to distributors should be prohibited.

(c) Monthly activity volume requirements may not include any purchases by distributors.

(d) Tracking of performance activity connected to wholesale purchasing should be banned.

Query, are the premises for justifying the new FTC enforcement position well founded?

Although reasonable minds may differ, history does not necessarily support the Chairwoman's position. Does it matter? Probably. Why? When a new proposed enforcement policy may so profoundly impact the business and legal landscape, it is worth visiting the issue. Although the "black and white" terms may have been **quite acceptable to Herbalife in its own factual circumstances,** those stringent mandates are at odds with how the mainstream direct selling industry has operated for many decades and may prove quite disruptive. At a minimum, the threat of FTC prosecution, pursuant to the new suggested paradigm, has caused major uncertainty in the direct selling community … with attendant options of "fight," "capitulate" or "find common ground."

Abandoning Amway

In abandoning support for the ***Amway Safeguards Standard***, Chairwoman Ramirez stated as a premise:

I want to note that, although this is less common today, in the past some MLMs have sought to rely on policies similar to those referenced in the Commission's 1979 Amway decision – specifically, the so-called "buy-back," "70 percent," and "10 customer" rules – as a sufficient basis for assuming that their product is purchased by real customers to satisfy genuine demand. This reliance is misplaced. The Commission found those policies were effective given the specific facts in Amway,[17] but neither the Commission nor the courts have ever endorsed those policies for the MLM industry at large.

FTC: Industry reliance on the Amway Safeguards standard is misplaced in that it is not such an important legal precedent to the courts.

Well, this is not quite accurate. Actually, Amway has been an integral part of a "gold standard legal analysis" for 40 years in most leading cases right up to, and including, the most recent case, U.S. Court of Appeals for the Ninth Circuit ruling, ***FTC v. BurnLounge, Inc.*****,** 753 F.3d 878 (9th Cir. 2014).

BurnLounge is typical of reliance on the ***Amway*** standard by courts in leading decisions. It is part of a fabric of decisions, such as ***Koscot***, that contribute to the analysis, with the understanding that application of the ***Amway*** analysis was fact

driven and, important, but not determinative, of the final conclusion. For instance, the ***Omnitrition*** court noted that, in the presence of inventory loading, adherence to the ***Amway Safeguards*** did not guarantee "safety." Similarly, where the evidence was that distributor purchases were primarily motivated by desire to qualify in the plan, no safety existed. (***BurnLounge***) Or where there was no encouragement to mandate retail sales or promote retail sales, safety disappeared. (***Amway***) And, if a company failed to enforce the ***Amway Safeguards*** standard or fell short of its implementation, no safety existed. But, nevertheless, courts embraced the ***Amway Safeguards*** standard and relied on it, along with the original ***Koscot*** mandate that compensation must be tied to sales to the "ultimate consumer" as a base starting point in pyramid cases. And, whether or not the FTC future prosecutions move away from pyramid bases to mere allegations of "unfair practices that are likely to cause injury to the public," it is difficult to imagine courts not returning to 50 years of pyramid case analyses when faced with prosecution of a direct selling company.

In actuality, the *BurnLounge* court cites *Amway* multiple times. Here, in the *BurnLounge* decision, the Court

indicates that the *Amway* precedent is alive and well in current court analysis:

In contrast, in ***Amway*** the FTC found that an MLM business was not an illegal pyramid scheme. *In re Amway*, 93 F.T.C. at 716-17. Though Amway created incentives for recruitment by requiring participants to purchase inventory from their recruiters, it had rules it effectively enforced that discouraged recruiters from "pushing unrealistically large amounts of inventory onto recruits." *Id*. at 716. BurnLounge argues that "[t]he only difference between ***Amway*** and BurnLounge is that BurnLounge *did not require* inventory purchases." This argument is unpersuasive because BurnLounge required Moguls to purchase a product package to get the chance to earn cash rewards, provided cash rewards for the sale of packages by Mogul's recruits, and had *no* rules promoting retail sales over recruitment.

And similar analysis and respectful reference to the ***Amway safeguards*** is to be found, over four decades of legal rulings, cited sometimes in passing, and also frequently in-depth, in more than two dozen reported cases.

Creating a New Legitimacy Paradigm

FTC: The Settlement terms in FTC/Herbalife represent a more appropriate approach for the analysis of legitimacy:

Among those terms:

Only one-third of MLM compensation to upline should come from personal use by downline distributors, whether or not such purchases are reasonable in quantity for use by the distributor "ultimate user."

In her presentation, notwithstanding almost 50 years of ***Koscot*** reference to "ultimate user," the Chairwoman argues that "ultimate user" must be defined as a "real customer," and that a "real customer" only "fits the bill" if that customer is a nonparticipant retail customer. This description represents a "sea change" in what is an "ultimate user," defies codified recognition of "personal use" in more than a dozen states and goes begging for support in a long lineage of case law.

And, the one case cited by the Chairwoman to demote legitimacy of personal use, ***Omnitrition***, was actually a case that highlighted the major abuse of Omnitrition International, in failing the ***Amway*** standard, by requiring distributors to engage in "inventory loading," buying "exorbitant amounts of products"

and "thousands of dollars of products" in order to qualify for commissions in the program. Although a reference, in passing, is made to the effect that personal use alone may not satisfy sales to the "ultimate user," no language in ***Omnitrition*** suggests or justifies devaluing "personal use" by two-thirds. Again, the gravamen of abuse in the case was promotion of inventory loading to qualify for commissions, and not "personal use."

Other than the passing reference in ***Omnitrition***, no court case has ever challenged the "giving of credit" for "personal use in reasonable amounts" as voiding the transaction as a sale to an ultimate user, let alone, limited such credit as drastically as the FTC suggests should be considered as the legal standard. It is true that courts have condemned inventory loading and have examined for factual evidence that purchases were for "qualification" rather than reasonable use. But, they have not rendered personal use purchases "second class citizens" in the world of direct selling. In fact, as noted, more than a dozen states have codified the recognition of personal use purchases as legitimate end destination ultimate user purchases, which are due full credit.

The FTC is effectively proposing to ***reverse the presumption that one buys product to be used, until shown otherwise***, into a presumption that, if a distributor buys a product, the presumption is that the purchase is for nefarious qualification purposes of recruitment such that the purchase does not deserve full credit in the sales process.

The FTC is seeking to achieve by "guidance" what it could not get a court to accept in ***BurnLounge***. In the ***BurnLounge*** appeal the FTC argued against validation of personal use purchases. However, the FTC position was rejected by the U.S. Court of Appeals for the Ninth Circuit in ***BurnLounge***:

The FTC counters that "internal sales to other Moguls cannot be sales to ultimate users consistent with Koscot." Neither of these arguments are supported by the case law. (Page 18 of opinion)

And this "scarlet letter" on personal use, is contrary to the FTC's own position in its 2004 Advisory Opinion:

Internal Consumption

Much has been made of the personal, or internal, consumption issue in recent years. In fact, the amount of internal consumption in any multi-level compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme, The critical question for the FTC is whether the revenues that primarily support the commissions paid to all participants are generated from purchases of goods and services that are not simply incidental to the purchase of the right to participate in a money-making venture.

It is important to distinguish an illegal pyramid scheme from a legitimate buyers club. A buyers club confers the right to purchase goods and services at a discount. If a buyers club is organized as a multi-level reward system, the purchase of goods and services by one's downline could defray the cost of one's own purchases (i.e., the greater the downline purchases, the greater the volume discounts that the club receives from its suppliers, the greater the discount that can be apportioned to participants through the multi-level system). The purchase of goods and services within such a system can, therefore, be distinguished from a pyramid scheme on two grounds. First, purchases by the club's members can actually reduce costs for everyone (the goal of the club in the first place).

Second, the purchase of goods and services is not merely incidental to the right to participate in a money-making venture, but rather the very reason participants join the program. Therefore, the plan does not simply transfer money from winners to losers, leaving the majority of participants with financial losses.

And, even the FTC's primary expert economist in many of its pyramid prosecutions, including ***BurnLounge***, Dr. Peter Vander

Nat, has shrugged off the need to "penalize" or automatically stigmatize a personal purchase sale:

Below is an excerpt from Dr. Vander Nat's deposition in the **BurnLounge** case:

Vander Nat *BurnLounge* deposition on issue of internal consumption... November 12, 2008:

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Q. Under the heading internal consumption, the second sentence. "In fact the amount of internal consumption in any multilevel compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme." Do you agree with that sentence?

A. I think so. Yes. I think that that is consistent with what I said this morning on this point.

Q. What if the sentence read a little differently? What if the sentence read the amount of internal consumption in any multilevel compensation business is not a factor in the analysis of the FTC's determination of whether or not a plan is a pyramid? Would you still agree with the sentence?

A. I think I would. I said this morning, when I think back on this testimony, that I expect there to be internal consumption in the organization and the fact that it's there is itself not determinative one way or another. I think I said that

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Q. And that is the sales that you consider in your analysis. And you exclude from that sales within the distribution network.

A. I said I exclude from it those purchases that people are required to make in order to enter the business opportunity. That's exactly what I said about it.

Q. And isn't that at least some of what internal consumption is?

A. No. I don't think that that's what's being referred to here. I mean, normally when you're talking about internal consumption, if you just use the word generally, it means people wanting to use the product for their own use just because they like the product. I mean, that's normally what the phrase refers to. And I simply made this other qualifier about it. Whatever you are required to purchase of consumable goods in order to enter the business opportunity, I count that as part of your business investment because you're required to buy it as part of the investment

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Q. Do you have any opinion as to a percentage of sales within a distribution network of a company that would not make it more likely that there be a finding of pyramid?

A. No. As I've said, internal consumption doesn't count one way or another with me. I've given all the factors that I use. Internal consumption is itself not one of the factors.

And notwithstanding his declarations in many FTC pyramid prosecutions that "retail sales" are the dividing line, Dr. Vander

Nat cuts to the chase in his *BurnLounge* deposition that, in fact, the acid test is whether or not distributors are making payments as a gateway to the business opportunity, i.e. purchases incidental to the business opportunity. In this regard, he is on the same wavelength as both the case law, 2004 FTC Advisory opinion and the position of the direct selling industry.

Page 130 of the Vander Nat *BurnLounge* deposition:

I believe in the Mogul program people are buying the product for the sake of a business opportunity. That's why they're buying it. So the VIP package has a certain business value which is distinct from the exclusive package as a business value which is again distinguished from the basic package as a business value. I am basing the analysis on this basic premise in the Mogul program people are buying into a business opportunity. They're paying what in essence is a business investment for them. The fact that it has some consumable items in it, that may be beneficial to them, but they're buying it for the sake of the business opportunity. Therefore the issue of whether they're harmed is for me they went into a business in the hopes of making money but in fact they have a business loss. So for me the business loss is the harm.

The Other New Legitimacy Rules on the FTC Horizon

How do those other new mandates that upend decades of industry practice fit into the legal landscape?:

1. Autoship to distributors should be prohibited.

2. Monthly activity volume requirements may not include any purchases by distributors.

3. Tracking of performance activity connected to wholesale purchasing should be banned.

Actually, in 50 years of case authority on pyramid schemes, the courts have condemned inventory loading, earnings misrepresentations, lack of incentives on retailing, absence of return policies, programs that inadequately enforce the ***Amway Rules*** or pay out rewards on sales to those who are not what ***Koscot*** referenced as "ultimate users."

But, in the presence of adequate safeguards under ***Koscot, Amway*** or ***BurnLounge***, no court has insisted on the type of restrictions called for by the FTC. If the FTC has the muscle to impose such marketing prohibitions, it will likely be due to "extra judicial" factors rather than reliance on the existing legal standards of 50 years of case authority.

The FTC will also need to buck an opposite trend in more than a dozen states and a proposed congressional action, **H.R.5230,** a bi-partisan anti-pyramid bill to codify recognition of personal use purchases and establish **legitimacy** standards acceptable to the direct selling industry. The bill is sponsored by Marcia Blackburn, member of the Presidential-Elect Transition Team and other bi-partisan sponsors in a post-2016 election environment that is decidedly "anti-regulatory," where one incoming cabinet member is a family owner of Amway, where a President-Elect was formerly the branded spokesperson for multiple direct selling companies, where one prominent congressional committee chair was previously a ten-year employee of a leading direct selling company and where the incoming President appointed a Special Advisor for reduction of the federal regulatory burden, Carl Icahn, a 23% shareholder of Herbalife, one of the world's largest direct selling companies.

In addition, the FTC Act provides for the President to appoint 5 commissioners to 7 year terms, the composition of which may be 3 from one party and 2 from another. Currently, there are 3 commissioners, 2 Democrat and 1 Republican. After the new President appoints two new commissioners, the likelihood is 3 Republican and 2 Democrat. And the President is entitled to

name the Chair of the FTC Commission. In other words, the positions of Chairwoman Ramirez may prove to be short term in duration as a less burdensome regulatory environment is ushered in over the next few years.

And so, the question: Ratchet up the regulation or ratchet down the regulation? Only time will tell. Better yet … this is a good time for the FTC and direct selling industry to find common ground and workable rules that will allow the industry to prosper in an effective and ethical manner.

Please click here to read the actual speech of FTC Chairwoman Ramirez.

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Post Script:
On January 13, 2017, Edith Ramirez, the chairwoman of the **Federal Trade Commission** announced her resignation, effective Feb. 10, 2017.

For analyses articles (and actual case documents) on the ***BurnLounge*** appeal decision and post-***FTC v. Herbalife Settlement*** legal guidance, please visit www.mlmlegal.com.

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Jeffrey A. Babener, of Portland, Oregon, www.mlmlegal.com, is the principal attorney in the law firm of Babener & Associates. He represents leading U.S. and foreign companies in the direct selling industry. He has been a key advisor to such companies as Avon, Herbalife, Discovery Toys, Nikken, Shaklee NuSkin, Excel, Usana, Fuller Brush, Cell Tech, Enagic, Sunrider, Melaleuca, Nerium International, etc. He is a frequent lecturer and has been interviewed on the industry, and published, in such publications as Money, Inc., Atlantic Monthly, Success, Entrepreneur, Kiplinger's Personal Finance, Home Office Computing, Business Start-Ups, Direct Selling News Magazine, and Money Maker's Monthly. He is editor of the industry publication, Direct Sales Legaline. Mr. Babener is also the author of the books; Tax Guide for MLM/Direct Selling Distributors, Network Marketer's Guide to Success, The MLM Corporate Handbook, Network Marketing: Window of Opportunity, and Network Marketing: What You Should Know (used as the college curriculum textbook at Utah Valley State course on network marketing). He is editor of one of most frequented network marketing educational web sites, www.mlmlegal.com . He has served as Chair of more than 70 national conferences on starting and running the direct selling company. He serves on the Lawyers Council and Government Relations Committees of the Direct Selling Association (DSA), and he has served as General Counsel and on the board of the MLMIA (Multilevel Marketing International Association). He has lectured at major industry trade meetings and at such educational institutions as the Univ. of Illinois, University of Texas, University of Houston, etc. He is a graduate of the University of Southern California Law School where he served as an editor of the USC Law Review, followed by the appointment as a law clerk to Hon. David Williams, U.S. District Court for the Central District of California.

A number of Babener & Associates client companies have been success stories over the last several decades, including several billion dollar and NYSE companies such as Avon, Herbalife, NuSkin, Usana. Other successful companies, to which the law firm has provided varying level of advisory, have included Melaleuca, Nikken, Enagic, Discovery Toys, Amazon Herbs, TriVita, Nerium International, Shaklee, PrePaid Legal, Tupperware, Primerica, Arbonne, Longaberger, Excel Communications, ACN, etc.

Mr. Babener has served as lead trial counsel for multiple cases on direct selling throughout the U.S. Further background material on direct selling will be found at the website, www.mlmlegal.com, where he is editor.