FTC v. Herbalife Settlement: First Take

By Jeff Babener, © 2016
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Is there a proper blessing for the Czar?
Of course. May God bless and keep the Czar... far away from us.
- Fiddler on the Roof

A Settlement is Reached

On July 14, 2016, the FTC and Herbalife concluded a multiyear investigation with a Stipulated Settlement that both, brought the investigation to a close, and delineated a going forward set of rules by which Herbalife would conduct its direct selling business. Given the fact that Herbalife is one of the largest global direct selling companies, the direct selling industry is quite focused on the meaning of the settlement to the industry, both short-term and long-term. And given the immense power of the FTC, the direct selling industry will wonder how much regulation it can withstand before it suffers irreparable harm.

Executive Summary:

1. Herbalife indicates a satisfactory result, and that it is comfortable that it can live and thrive with agreed restrictions.

2. The settlement is not legal precedent beyond Herbalife, nor binding on other direct selling companies.

3. Forward Looking: The FTC will likely argue, in the future, that the Herbalife restrictions should be viewed as a new legal standard and guidance for the direct selling industry. In the absence of significant resistance by direct selling companies, the direct selling industry, the Direct Selling Association and clarifying federal legislation, the possible onerous legal standards, that may be urged by the FTC, will be very damaging to the business of direct selling companies … and, another example of over regulation of small business, to the detriment of the $36 billion dollar industry and its 20 million entrepreneurial participants.

A Settlement Unique to the Facts and Parties

On its surface, the *FTC/Herbalife* settlement is an agreement, restrictions and all, unique to the parties' ***negotiations.***

1. This was a negotiation between equally sophisticated and strong parties, best

characterized as serious "horse trading."

2. Although there was a $200 million fine, Herbalife stock rose by nearly $1 billion the same day, the fine represented a mere two weeks of global sales... and a longstanding major hedge fund short challenge, which depended on an FTC shutdown scenario, appeared to be seriously impaired, certainly short-term, and possibly long-term.

3. Both sides could claim victory. To Herbalife's benefit, the FTC specifically omitted an allegation of pyramid in its press release, press conference, complaint and settlement document. However, the language of the "unanswered" Complaint (including a litany of accusations of earnings misrepresentations, paucity of positive earners, challenges to viability of the stand-alone opportunity, questioning of the "real world" market for product and other deceptive practices, etc.) and permanent restrictions of the settlement, allowed it to claim a major accomplishment. Obviously, Herbalife disputed the myriad of allegations, but was ready to move on. The corollary of the FTC "chest thumping" was that Herbalife could claim vindication and strength in the settlement, and that any "model" restrictions in the Stipulated Order were clearly in its comfort zone, and are only applicable to the U.S. market, which accounts for only 20% of global sales.

4. The FTC noted that it was spared, possibly, years of litigation, and likewise, Herbalife was spared the unknown risk of a preliminary injunction request or a long-term litigation "cloud" that could dramatically impact its business and stock value.

The Settlement is Not Legal Precedent

Most importantly, this settlement is not case precedent, it is not an FTC rule, it is not a statute and it is not even consistent with case authority or previous FTC public positions on legal standards for pyramid.

Although the Settlement focused on restrictions for compensation plan credit for personal use by distributors, no statute or adjudicated case has called out specific percentages of "retail mandates" or "restrictions on credit for personal use" as a specific element of pyramid case analysis. The leading case, *Koscot*, stated the legal pyramid standard as a requirement that commissions be based on sales to ultimate users. In the most recent legal precedent in *BurnLounge*, the court affirmed the *Koscot rule* and went on to state that pyramid cases are decided by a fact-based analysis of whether or not purchases by distributors are merely incidental to the business opportunity, or otherwise stated " is the primary motivation for distributor purchases a need for the product for resale or personal use exhibited by purchases in reasonable amounts, or is the primary motivation to qualify in the opportunity for rewards and recruit others to do the same."

More than a dozen states have explicitly recognized that distributor purchases in reasonable amounts should be recognized as sales to ultimate users. Even in its most aggressive posturing in litigation, where it has asserted that 50% of sales should come from nonparticipants, **the FTC has never suggested that credit for distributor purchases should be limited to one-third of purchases**, i.e., that nonparticipant sales must be 67%. In fact, in its 2004 Advisory Opinion, the FTC recognized the validity of personal use and even suggested the potential merit of an MLM buying club concept.

The direct selling industry, for 50 years, has tracked compensation on wholesale movement of product, with the assumption (accompanied by consumer safeguards such as anti-inventory loading rules, buyback policies, retailing mandates) that product is either resold or consumed by personal or family use. If it doesn't fit one of these categories, longstanding industry practices provide that it is subject to refund for 12 months after purchase. ***However, implicit in the FTC's approach in the Herbalife settlement is that the decades old approach of tracking commissions, based on wholesale movement of product, should be revisited and even rejected. No court decision, statute or regulation has ever challenged this standard industry practice. Rather, the going forward preference of the FTC may be that compensation should be tracked to sales to nonparticipants or limited personal use purchases. This "turnabout" would represent a wholesale change throughout the direct selling industry.*** Hopefully, the chasm between these two positions can be bridged in coming years.

There is another good reason to be skeptical that the FTC's position in a negotiated settlement is the "new gospel" of direct selling. **In its 2004 Advisory Opinion, the FTC stated that it has a regular practice of overreaching and "fencing in orders" in such situations:**

> *With regard to your second question, the Federal Trade Commission often enters into consent orders with individuals and companies that the Commission has determined have violated the FTC Act. To protect the public from those who have demonstrated unwillingness to follow the law, these orders often contain provisions that place extra constraints upon a wrongdoer that do not apply to the general public.* ***These 'fencing-in' provisions only apply to the defendant signing the order*** *and anyone with whom the defendant is acting in concert.* **They do not represent the general state of the law.**

Forward Looking... Searching for New Paradigms in Direct Selling

Because Herbalife had undertaken analysis to support its public assertion that more than 70% of its members join to be discount purchasers, as opposed to pursuing the MLM opportunity, the company appeared receptive to go forward redefining such individuals as nonparticipant retail customers and accept a rule that limited credit for distributor personal use at one-third of purchases, or that the majority of overall company sales should be to nonparticipants. In other words, it was "comfortable in its own shoes."

Only time and data, following adoption of a preferred customer classification, will demonstrate the validity and accuracy of the Herbalife analysis of primary "motivation" as a desire to purchase at discount. Herbalife will have the opportunity to seek to convert discount buying motivated distributors to the status of preferred customers, but it will be the decision of the distributor. In public communication, Herbalife has been clear that it is confident of its position that the majority of its members have joined for "discount buying" status.

As to its comfort level, said Herbalife Executive Vice President, Global Corporate Affairs, Alan Hoffman, in a July 20, 2016 Business Wire press release:

> ***After more than two years of working with the FTC, I think we understand the terms of the settlement agreement very well. We would not have settled unless we had the greatest confidence in our ability to comply with the agreement and grow our business and we believe this will be proven out over time.***

Obviously, many direct selling companies **will not feel comfortable** with the FTC position of disqualifying substantial personal use purchases for purposes of determining compensable sales volume. Whether or not other companies, if forced, can live with an increasing nonparticipant retailing mandate is an open question. And, when and how far the FTC will pursue their new approach is also an open question. And, what legislative relief industry organizations, such as the Direct Selling Association, will pursue is also an open question.

As to several settlement "model" requirements, they seem "in keeping" with the direction of **both industry and regulatory trends to reexamine and fine tune** company models:

1. Requiring reps to track sales to nonparticipant retail customer/ultimate users.

2. Avoiding earnings or potential "lifestyle achievement" hype.

3. Taking care to monitor that participants (nutrition clubs in the case of Herbalife) do not make losing investments.

4. Revisiting the extent and use of autoship to avoid inventory loading.

5. Capping the monthly amount of allowed purchases for personal or family use to avoid inventory loading.

The Gathering Storm for the Industry

Obviously, the industry applauded an amicable resolution for one of its leaders, Herbalife. Although Herbalife was comfortable with operating under new marketing rules, several of the rules, if applied to other companies, would be extremely onerous and challenging to their business and to models that have been successful in the marketplace for 50 years, and will view the restrictions as another example of government micromanagement of the small business sector that has, in fact, responsibly self-regulated, voluntarily, and already adopted wide-ranging consumer safeguard "best practices" ranging from anti-inventory loading to prohibitions on earnings misrepresentations to one-year buyback policies for inventory and sales support materials:

1. A requirement that only one-third of distributor purchases for personal or family use may be credited for computing sales volume for commission purposes.

2. Distributors are limited to a "cap" amount of monthly product purchases.

3. Autoship programs, which allow orderly distributor product purchasing, via monthly "standing orders," **are prohibited**. (Nearly all direct selling companies have employed "standing order" options for decades and "standing order" programs are commonplace in both the commercial and retail sectors.)

4. Distributor fulfillment of minimum personal sales volume requirements are prohibited, or must be fulfilled by sales to nonparticipants... again, excluding credit for personal/family use consumption.

5. Total company commission payments are limited, in the absence of demonstration of 80% sales to the combination of nonparticipants and allowable limits (one-third) of distributor personal consumption purchases.

6. Beyond the historical "pyramid" basis of prosecution, the FTC will now prosecute direct selling companies for deceptive/unfair practices if they deem that the marketing program is “likely to cause substantial injury to consumers”. This standard is subjective and arbitrary and may include a myriad of accusations such as "low distributor earnings" or claims that companies overstate earnings expectations. In other words, no certainty for businesses. Question: What is "substantial injury”? Answer: What day of the week is it?

Going Forward

It is a reasonable hypothesis that the *Herbalife* settlement, in the short term, will not change the business model of other leading companies, without further regulatory or legislative action, but it clearly creates regulatory uncertainty for all companies. And, it certainly will be timely for all direct selling companies to discuss a preferred customer program, retailing mandates and product tracking to ultimate users.

Herbalife has indicated that it will be able to live with the new restrictions, as the negotiated settlement was tailored to issues between Herbalife and the FTC. It would have made no sense to agree to terms that would interfere with the viability of business. **However, if the cumulative new restrictions were forced across the direct selling industry, might the result be severe damage to the direct selling industry? Absolutely. Can an industry be "over-regulated to death?" Absolutely.** The FTC’s next move will be keenly watched, as will the efforts of the Direct Selling Association to look out for the industry, either in dialog with the FTC or introduction of federal direct selling legislation that mirrors the MLM legislation of many states. It is definitely a "fork in the road" time.

Read the next article in the *FTC v. Herbalife* series: *FTC v. Herbalife: Post-Settlement Legal Guidance for the Direct Selling Industry*

For actual copies of *FTC v. Herbalife* documents, please visit www.mlmlegal.com

Or, view the PDF documents below:

FTC v. Herbalife Stipulated Settlement

FTC v. Herbalife Complaint

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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.

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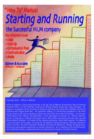

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