

FTC Order May Guide Cos. In Avoiding Pyramid Scheme Label

By **Branko Jovanovic and Lia Bozzone** (June 28, 2023)

While the direct-selling world was awaiting U.S. District Judge Barbara Lynn's decision in *Federal Trade Commission v. Neora LLC*, in which the FTC alleged that Neora operated an illegal pyramid scheme, the *FTC v. Noland* case largely flew under the radar.

After all, the egregiousness of the defendants' conduct made the finding that Noland's company, Success By Health was a pyramid scheme a foregone conclusion. However, the U.S. District Court for the District of Arizona's May 11 decision provides invaluable information regarding the aspects of SBH's business model, and policies and procedures that led the court to determine that SBH was running a pyramid scheme.[1]

In determining whether SBH ran a pyramid scheme, the court's analysis focused on the two prongs of the Koscot test,[2] which characterizes a pyramid scheme as a program in which participants pay money to a company for the rights to sell a product, and receive — in return for recruiting other participants into the program — rewards unrelated to sale of the product to ultimate users.

Below we discuss the court's findings with respect to the two prongs of the Koscot test.

The First Prong of the Koscot Test

When assessing whether the first prong of the Koscot test was satisfied,[3] the court determined that "[t]here is no genuine dispute of material fact regarding the satisfaction of prong one of the Koscot test with respect to SBH." [4]

More specifically, there is no "dispute that consumers were required to pay an annual fee of \$49 to be SBH Affiliates" and that, "by paying this fee, Affiliates gained the right to sell SBH products on their [replicated SBH] webpage." [5]

The court's determination that there is no dispute regarding whether the first prong of the Koscot test was satisfied implies that this criterion will be met by any direct selling organization that charges its distributors an annual fee or requires prospective distributors to purchase a starter kit. In other words, all of these organizations would fail the first prong of the Koscot test.

The Second Prong of the Koscot Test

The second prong is satisfied when "participants purchase the right to earn profits by recruiting other participants, who themselves are interested in recruitment fees rather than the sale of products." [6]

Citing the U.S. Court of Appeals for the Ninth Circuit precedent from the 1979 *In re: Amway Corp.* case and the evidence from the bench trial, the court concluded that the second prong of the pyramid scheme test is also satisfied.[7] In support of its conclusion, the court



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emphasized four interconnected findings:

1. SBH paid commissions based on purchases from SBH, rather than on the resale of those products to retail customers;[8]
2. SBH sales volume was not driven by genuine demand but instead by strategic buying;
3. Defendants failed in their attempt to show that retail sales provided a significant source of rewards;[9] and
4. Defendants placed heavy emphasis on recruiting and relatively little emphasis on retail sales;[10]

Below we have assessed the first three points and the implications they may have on your company's business model.[11]

SBH paid commissions based on purchases from SBH rather than on the resale of those products to retail customers.

SBH, like many other direct selling organizations, did not track sales to direct customers and paid commissions based on affiliates' wholesale purchases from SBH, rather than on affiliates' sales to retail customers.[12]

Furthermore, the court found that:

Defendants drove SBH sales by pushing recruitment, taking advantage of the momentum from recruitment to sell large up-front product packs, urging large monthly purchases to stay on the path to financial freedom, and encouraging one's recruits to do the same.[13]

Paying commissions on retail sales, a condition imposed on Herbalife International Inc. by the FTC in 2016 in the U.S. District Court for the Central District of California,[14] implies that distributors must provide documented evidence of retail sales in order to receive compensation and advance to higher ranks.

Establishing a preferred customer program and documenting retail sales would greatly assist direct selling organizations in efforts to document genuine consumer demand for its products, and enable them to provide stronger direct evidence that distributors are able to earn money through retail sales — i.e., buying at a discount and selling to retail customers in the field at a higher price.

The court notes that during closing argument, the FTC acknowledged that:

If, in a different set of facts, there was evidence that the downlines were turning around and really making robust retail sales from these products ... that might not qualify as a pyramid scheme because of those retail sales.[15]

SBH sales volume was not driven by genuine demand.

The court noted that "[i]t speaks volumes that SBH experienced a 95% decrease in sales volume after the receiver took control and eliminated the commission structure that was previously in place." [16]

The order also said:

Such a dramatic change suggests that the primary motivation for purchasing SBH products was not true consumer demand, such as a desire to resell the products in retail transactions or consume the products for personal satisfaction, but the hope that such purchases would lead to (or maximize or preserve the availability of) commissions.[17]

Furthermore, the court noted that:

Purchases of SBH products would spike on the last day of each month, that nearly 95% of the purchases from SBH were made by SBH affiliates, and that SBH affiliates were economically incentivized (and aggressively encouraged) to use monthly purchases to maintain the "rank" necessary to qualify for increased commissions.[18]

In other words, the order emphasized that SHB's sales were not driven by genuine demand but rather by strategic purchases. Establishing sales volume consistent with strategic sales is an imperative for any direct selling organization. Additional examples of strategic purchasing are instances where distributors are near the amounts necessary to qualify for various rewards.

Relatively low purchase volume clustering near qualification thresholds would indicate that purchases are driven by consumer demand, rather than by distributors desire to reach the threshold necessary to receive payments from the direct selling organization — and, thereby, participate fully in the rewards of the compensation plan.

Moreover, if the percentage of the direct selling organization volume purchased by new distributors — often referred to as front loading — constitutes a relatively low share of overall volume, this would suggest that the direct selling organization's operations and upline distributors are not reliant on payment front-loading from new distributors.

Defendants failed in their attempt to show that retail sales provided a significant source of rewards.

The court noted that the defendants "failed in their attempt to show that retail sales provided a significant source of rewards,"[19] and "failed to track retail sales and placed no restrictions on affiliates' ability to order more products while they still had excessive inventory on hand."[20]

Instead, the defendants "made little effort to create the sort of safeguards against inventory-loading that other MLMs often utilize."[21]

In fact, they

adopted an official no-refunds policy, often required (and otherwise strongly encouraged) automatic monthly orders, and threatened to bring civil and criminal charges against affiliates who requested refunds or made chargeback requests even when product orders went unfulfilled by the company for months on end.[22]

In addition to the need to document distributors' retail sales discussed in Section B.1, it appears crucial for direct selling organizations to avoid automatic monthly orders[23] and

establish a robust and comprehensive return policy.[24]

Generally, the automatic monthly orders are closely related to minimum purchase requirements, thus providing convincing evidence that the loyalty programs are not being utilized to buy product based on genuine demand; rather, they are likely being used to satisfy the monthly qualification requirement to earn various bonuses and commissions.

The court also noted the restrictions on retail sales that limited their viability:[25] SBH barred affiliates from making retail sales on Amazon or eBay — a practice adopted by many direct sellers — and selling products below the suggested retail price,[26] and SBH's products lacked UPC barcodes, which prevented affiliates from reselling products through local retail businesses.

Implications of Noland Order on Direct Selling Industry

While it may be too early to assess how the Noland order will affect the FTC's posture toward the direct selling industry, the order provides a set of criteria for assessing the legality of a direct selling organization's business model and guidance for the companies aiming to minimize their regulatory exposure.

In particular, direct selling organizations should consider the following measures.

Direct sellers should enhance the ability to prove that the vast majority of sales are consistent with genuine demand for their products:

- Incentivize consumers who are not interested in the business opportunity to enroll as preferred customers, or similar title, rather than distributors; commence the preferred customer program if it is not already in place.
- Mandate tracking of retail sales.
- Discontinue auto-ship programs, especially if the prescribed amounts are consistent with the minimum purchase requirement.
- Analyze business intelligence data to determine the share of sales volume potentially consistent with front loading — disproportionate share of volume coming from the new distributors — and strategic buying, like purchases around the qualification thresholds and/or placed toward the end of the month.
- Require distributors to designate their personal consumption purchases as such at the time of the order.
- Consider removing the practices that can be viewed as impediments to retail sales:
 - Provide distributors with the means to place the product via online and in-person marketplaces; and
 - Allow distributors to set their own resale prices within reasonable limits to prevent compensation plan manipulation.

They should also ensure that at least the majority of the commissions are paid on the sales to final customers instead on distributors' wholesale purchases.

Lastly, direct sellers should implement a robust return policy that would allow distributors to "undo" their investment in the business opportunity.

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[1] Order In Re Federal Trade Commission v. James D. Noland, Jr. et al., In the U.S. District Court for the District of Arizona, May 23, 2023 ("Order").

[2] The Koscot test, which was adopted by the FTC in 1975 as a means of characterizing pyramid schemes. Koscot 86 F.T.C. at 1180. Summary available at <https://www.ftc.gov/public-statements/1998/05/pyramid-schemes>. After the FTC's initial adoption of this test, its use has been affirmed in multiple federal court opinions, including Omnitrition (1998), Gold (1999), and Burn Lounge (2014).

[3] The first prong of the pyramid-scheme test "can be satisfied by a required purchase to become [an affiliate]" or a "required purchase of non-returnable inventory to receive the full benefits of the program." FTC v. Vemma Nutrition Co., 2015 WL 11118111, *3 (D. Ariz. 2015).

[4] Order, p. 80:4–5.

[5] Order, p. 80:7–9.

[6] In re Amway Corp., 93 F.T.C. 618, 716 (1979). In the Ninth Circuit, an MLM business may be considered an illegal pyramid scheme if "the rewards the participants received in return were largely for recruitment, not for product sales." In re Amway Corp., 93 F.T.C. 618, 886 (1979).

[7] Order, p. 81:3–4.

[8] Order, p. 81:4–6.

[9] Order, p. 84:5–6.

[10] Order, p. 82:20–21.

[11] For a legal assessment of Noland see i.e. Winston and Strawn LLP's blog post available at <https://www.winston.com/en/direct-sellers-update-regulation-law-and-policy/the-success-by-health-ftc-v-noland-decision-and-its-impact-on-the-direct-sales-industry.html>.

[12] The FTC does not require MLMs to retain sales receipts, but its guidance states that "to comply with the FTC Act, the compensation structure of an MLM must be based on actual

sales to real customers. Thus, documentation of actual sales to real customers provides relevant information concerning an MLM's compensation structure." See "Business Guidance Concerning Multi-Level Marketing," Question 8, Does the FTC Act require MLMs to retain sales receipts?, January 2018, <https://www.ftc.gov/tips-advice/business-center/guidance/business-guidance-concerning-multi-level-marketing>.

[13] Order, p. 82:8–11.

[14] See Herbalife Stipulation, page 8, available at <https://www.ftc.gov/system/files/documents/cases/160715herbalife-stip.pdf>.

[15] Order, footnote 47.

[16] Order, p. 83:15–17.

[17] Order, p. 83:18–22.

[18] Order, p. 83:23–27.

[19] Order, p. 84:5–6.

[20] Order, p. 55:25–26.

[21] Order, p. 84: 17–18.

[22] Order, p. 84:18–22.

[23] For example, The Stipulated Order in the FTC's case against Herbalife states that "Business Opportunity Participants are prohibited from participating in any auto-shipment program or any similar program involving standing orders of product." Herbalife Stipulation, p. 12, <https://www.ftc.gov/system/files/documents/cases/160715herbalife-stip.pdf>.

[24] For example, The Herbalife Stipulated Order required the company to protect overly optimistic distributors against significant losses by providing an "undo" option. Specifically, all distributors are entitled to a full refund—including any taxes, fees, and shipping costs—for any unopened products purchased within the previous twelve months. New distributors can also obtain a full refund for the cost of any start-up package for at least their first twelve months with the company, with return shipping costs paid by the company. Herbalife Stipulation, p. 12, <https://www.ftc.gov/system/files/documents/cases/160715herbalife-stip.pdf>.

[25] Order, p. 47:26–48:5.

[26] Judge Lanza notes that "[s]uch price floors not only prohibited consumers from pricing products at a level that consumers wanted to pay, but also prohibited them from competing with Defendants themselves, who offered products direct to the public at 'wholesale' rather than 'retail' price." Order, p. 48:8–11.