DirectSellingNews®
Serving the Direct Selling and Network Marketing Executive Since 2004
Join the Direct Selling News Community

Direct Selling News

New Perspectives

Herbalife: What the Short Sellers Missed on the Way to the Press Conference

September 01, 2013

by Jeffrey A. Babener

Editor's Note: The following is a summary of an article written by Jeffrey A. Babener. The full article contains references to court cases and further explanation of each topic. To read the full article, go to www.mlmlegal.com.

History repeats itself. Just as Yogi Berra famously said, "It's déjà vu all over again."

The 2012 billion-dollar short seller attack on Herbalife, a 32-year-old NYSE listed direct seller of nutritional products in 80-plus countries with annual sales in excess of $3 billion, is a replay of the seminal challenge to the MLM/Direct Selling model won by Amway in 1979 [*In the Matter of Amway*, 93 F.T.C. 618 (1979)].

In that 1970s FTC challenge, the criticism went to whether or not the core of the MLM referral selling model was a "deceptive" way to market. Similarly, in the 2012 short seller attack on Herbalife, along with other criticisms, a principal complaint was that evidence of "substantial personal use and consumption" of company products by distributors themselves renders an MLM/Direct Selling model inherently deceptive and an illegal pyramid scheme. Armed with multi-hour slide presentations, short sellers and financial bloggers predicted that a direct selling program, in which substantial product is purchased by distributors for personal use, is doomed to collapse as an illegal pyramid scheme and that federal agencies should step in to hasten that demise.

Is this legal analysis correct, and is the call to federal action justified or predictable in light of the 40-year legal history of direct selling?

Does the answer lie in the follow-up and prolific financial blogging that focuses on algorithms, multiple regression analysis and economist “speak” about “who uses the product?” Perhaps not. Rather, the answer to whether or not an MLM/Direct Selling program is a pyramid, for which federal prosecution is justified and predicted, may be driven by a case-by-case fact scenario that answers a “gut instinct,” as noted by Justice Potter Stewart (on pornography)… “I can’t define it, but I know it when I see it.”

In the case of direct selling, the operative question appears to be: Is the program “inherently deceptive” and an “egregious abuse” of consumers, and is the driving force behind payment of money for products the desire to qualify in an MLM plan? In other words, are distributor purchases and payments incidental to the business opportunity or are payments made merely as a “gateway” to a business opportunity? This is a different issue than the question of the amount of internal consumption or personal use by distributors, even if it is incentivized by a compensation plan. Further, do today’s established direct sellers deserve to be placed in the same gene pool as companies that have been the target of federal prosecutions?

A close look suggests that it may be time to reassess the situation. Some very salient facts and cases seem to have been missed in the rush to challenge direct sellers. First and foremost, it appears that in the massive releases of the Herbalife short seller and in the prolific financial blogging “call to action” that Herbalife is a pyramid and should be prosecuted by the FTC, individuals may not have actually examined the facts of leading FTC, SEC and Justice Department pyramid prosecutions over the last two decades. **Had they done so, they might have observed that a significant chasm exists between inherently deceptive and egregiously abusive pyramid schemes and the practices of leading direct selling companies.**

Furthermore, these individuals seem to have missed the FTC’s own statements on personal use, as well as the trending legislation in more than a dozen states recognizing the validity of personal use as a legitimate end destination of product.

Some Background

The MLM/Direct Selling/Network Marketing business model was off to a robust start in the 1950s with the success of companies such as Amway, Mary Kay and Shaklee. Not long thereafter, imposters and inherently deceptive pyramid headhunting recruitment schemes came along, emphasizing recruitment of participants to earn money without putting focus on selling products to consumers.

Two promotions founded by Glenn W. Turner, Dare to Be Great (motivational seminars and materials) and Koscot Interplanetary (cosmetics), prompted major prosecutions for pyramiding.

ESTABLISHED DIRECT SELLING COMPANIES

This business model has been validated by the FTC, the SEC and by federal court decisions.

They offer financial incentives for personal use, product promotion and salesforce expansion.

The primary revenue source and primary funding source for commissions derive, not from upfront purchases, but from ongoing and deliberate sales of products and/or services to outside customers or—in reasonable amounts—to distributors for personal or family use.

The *“I know it when I see it”* Pyramid Spectrum

INHERENTLY DECEPTIVE, EGREGIOUSLY ABUSIVE SCHEMES

These types of schemes have been prosecuted by the FTC and clearly defined as illegal.

Recruits are urged to pay money or purchase product as a “gateway” to qualify for rewards in a business opportunity, and payments are incidental to the business opportunity.

They are characterized by upfront investments for inventory, training, administrative services or bogus products to “buy in” to the opportunity for rewards.

The primary revenue source and primary funding source for commissions are the gateway purchases upon entry to the opportunity.

2013 © Direct Selling News.

Virtually every state had residents who were impacted by this and other programs, which officials successfully argued were mere “headhunting” schemes.

During this time, the FTC established the earliest guidelines regulating illegal pyramids and other unlawful entrepreneurial chains. In *In Re Koscot Interplanetary Inc.*, 86 F.T.C. 11106 (1975) (inventory loading of cosmetics), the FTC was highly critical of:

1. Large membership fees,
2. Front-end loading and inventory loading,
3. Programs in which distributors were misled as to the amount of commissions they might reasonably earn, and
4. Programs in which commissions were not based on the sale of product to the ultimate users.

In fact, the *Koscot* case established the legal standard for pyramid analysis that has threaded its way intact from that case to the 1979 FTC *Amway* case to the 2012 *FTC BurnLounge* case [*FTC v. BurnLounge*, U.S. District Court, Central District California, Case CV 07-3654-GW (FMOx) (2012)], leaving the question: *Are there rewards earned unrelated to the sale of product to ultimate users?*

This is a critical question, because at the core of the short seller accusation is the claim that a purchase for personal use by distributors (otherwise known as internal consumption) cannot be considered a sale to an ultimate user. If this standard were to be adopted, it would cast a cloud over many well-established direct selling companies, particularly those that sell consumable products such as health, home and personal care.

The Securities and Exchange Commission (SEC) also stepped into the Dare To Be Great picture, demonstrating that securities statutes also apply to the industry. In *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476 (1973), the U.S. Ninth Circuit Court of Appeals reaffirmed that the securities acts were “designed to protect the American public from speculative or fraudulent schemes of promoters.” Like other pyramid schemes, the only “commodity” that moved through this program was money. There were no viable goods or services sold at fair market value accompanying the recruiting activities.

In *In Re Koscot Interplanetary Inc.* (1975), the FTC established the earliest guidelines regulating illegal pyramids and other unlawful entrepreneurial chains.

Basically, individuals were invited to pay money to attend motivational seminars where they were trained to go find others to do the same, and so on. The Dare To Be Great program was ruled to be an “investment contract” under the securities laws and thus subject to regulation by the SEC. This was a landmark ruling in establishing the distinction between “speculative or fraudulent schemes” and legitimate direct sales activities. It also helped establish the SEC’s role in upholding the rights of legally operating companies and the right to prosecute offenders.

The *Koscot, Dare To Be Great*, and other pyramid cases left a sour taste in the mouth of the American public. And so, the legitimate direct selling industry had a close call in the 1970s when the FTC accused Amway of being an illegal pyramid scheme rather than a legitimate business opportunity. Fortunately for Amway and the entire industry, a 1979 administrative law decision declared the Amway business model to be legitimate and applauded various consumer safeguards, including the buy-back policy for unsold inventory, curbs on inventory loading and emphasis on moving product to the ultimate user *[In the Matter of Amway*, 93 F.T.C. 618 (1979)].

And so it went for the next 40 years and to this day. Federal agencies, such as the FTC or SEC or the U.S. Justice Department, did not chase after well-established direct selling firms, but rather they sought out inherently deceptive

schemes that defrauded the consumer of business opportunities. Hardest hit were offerings with large upfront investments of cash or inventory loading, nonrefundable fees, bogus products used as an excuse to move money, and so on.

The Practices of Established Direct Sellers

So we return to our question: Should decades-old direct selling companies be confronted again by federal regulatory agencies such as the FTC, SEC or U.S. Justice Department? After all, they clearly offer a financial incentive to consumers to use their products and services and to recommend those products and services to their family, friends and neighbors.

Truly, financial incentives have been one arrow in the quiver of the shaping of consumer spending behavior forever. These types of incentives include all frequent flyer programs, credit card reward programs, cash back loyalty programs, and every loyalty and referral program from every mom and pop diner and donut shop in America, not to mention warehouse clubs like Sam's Club and Costco Wholesale. Fortune 500 companies also embrace their customers as referrers who receive rewards for finding other customers, with well-known programs such as: MCI Friends & Family, United Airlines MileagePlus, American Express Membership Rewards and Amazon Associates, just to name a few.

In fact, the direct selling industry merely takes the referral rewards program one step further. Often pitching the positive experience of customers, companies offer a 1099 independent contractor business opportunity to those motivated to refer friends, family, co-workers and neighbors to patronize products that they themselves typically have used and enjoyed. The result in the U.S. is a thriving $30 billion industry with more than 15 million individuals involved and with publicly traded NYSE leaders including Avon, Herbalife, Primerica, USANA, Nu Skin and Tupperware. Worldwide, the direct selling industry comprises over $150 billion and 90 million individuals in over 100 countries.

And, notwithstanding the fondest dream of short sellers of NYSE direct selling companies to drive down stock prices by way of pyramid scheme allegations, the odds are diminished by the fact that—since the landmark approval of the multilevel marketing model in the 1979 seminal administrative law decision, *In the Matter of Amway*—no federal prosecutions have been aimed at multi-decade established direct sellers.

Since the landmark approval of the multilevel marketing model in the 1979 seminal administrative law decision, In the Matter of Amway, no federal prosecutions have been aimed at multi-decade established direct sellers.

In fact, attend a legal day symposium at the Direct Selling Association, and one is likely to find a representative of the FTC praising the work of the DSA and the contributions of member companies to the American economy and U.S. business expansion abroad. As a general matter, the facts in the cases of those companies prosecuted by the FTC look nothing like the programs of established and leading direct selling companies. The truth is that short sellers and critics seem to miss the clear dividing line between legitimate companies and pyramid schemes.

Jeffrey A. Babener is the principal attorney in the law firm of Babener & Associates. For more than 25 years, he has advised leading U.S. and foreign companies in the direct selling industry. He has also served as legal advisor to various direct selling companies listed on the New York Stock Exchange. See more of his articles at www.mlmlegal.com, where he is Editor.

Direct Selling News published this article at:
http://directsellingnews.com/index.php/view/herbalife_what_the_short_sellers_missed_on_the_way_to_the_press_conference#.UiZG1H_9zby