VEMMA LIVES TO PLAY ANOTHER DAY

By Larry Steinberg[1]
Shareholder, Buchalter Nemer

The sixteen month long lawsuit between the Federal Trade Commission and Vemma Nutrition Company has come to a negotiated resolution under terms which will allow Vemma to continue operating its business under restrictions similar to those contained in a federal court preliminary injunction entered against the company last September.

In August 2015, the FTC filed suit in Arizona federal court against Vemma, its CEO (BK Boreyko) and one of the company's top affiliates, accusing Vemma of operating an illegal pyramid scheme and of making false and misleading representations regarding the income potential of Vemma's business opportunity. As is its *modus operandi*, the FTC filed its lawsuit without notice and immediately obtained a temporary restraining order, appointment of a receiver to take control of Vemma's business, and an asset freeze. Eventually, Vemma was able to get the receiver removed (he was converted to a "monitor") and the asset freeze lifted, but remained under strict operating restrictions and court oversight pending trial (*http://tinyurl.com/FTC-Vemma-prelim-injunction*).

On December 15, 2016, the FTC announced that the Commission had unanimously approved the terms of a final settlement order with Vemma and the other defendants (*http://tinyurl.com/FTC-Vemma-settlement*). Vemma is barred from paying any compensation for recruiting, linking a participant's compensation to that participant's purchase of goods or services and, most significantly, from paying a participant *any compensation* unless the majority (*i.e.,* more than 50%) of the total revenue generated by the participant *and others within the participant's downline* is derived from sales to persons who are not participants in the business opportunity.

There are, of course, many other terms to the settlement, which is 42 pages in length. As is *de rigueur* for these types of settlements, the company is prohibited from making any express or implied misrepresentations regarding the business opportunity (including lifestyle claims) and from making any product claims unless such claims are supported by randomized, double-blind and placebo-controlled clinical studies conducted by qualified researchers. The settlement assesses significant (but not crippling) financial fines on the defendants, requires Vemma to file reports prepared by an independent third-party auditor for the next twenty years attesting to the company's compliance with the settlement terms, and imposes substantial compliance reporting and monitoring restrictions. Finally, the settlement includes a "death sentence" financial penalty of $238 million (which would be nondischargeable in bankruptcy) against both Vemma and Boreyko if it turns out that either defendant hid assets or materially misstated their financial condition during settlement negotiations. Notably, there is nothing in the settlement order which prohibits Vemma's CEO, BK Boreyko, from continuing at the company's helm.

[1] Larry Steinberg is an attorney who has been specializing in direct selling and network marketing since 2007, when he was tapped to represent BurnLounge as lead counsel in its seven year struggle against the Federal Trade Commission. A partner in the Los Angeles based law firm of Buchalter Nemer, Larry is chair of the firm's Multi-Level Marketing Practice Group. He is a graduate of Yale University and Harvard Law School. Larry is scheduled to be one of the featured speakers at the upcoming Direct Selling Legal and Compliance Summit 2017 on January 10-12, 2017 in Dallas. Larry will be participating in a panel entitled, "BurnLounge to Vemma to Herbalife: the Current Regulatory Environment."

© Lawrence B. Steinberg, Buchalter Nemer (2016)

What Does The Vemma Settlement Mean For the Network Marketing Industry

Those of us who advise network marketing companies on how best to stay out of the way of the Federal Trade Commission are, by necessity, in the business of reading tea leaves. The FTC's settlement with Vemma has now given us all another tea leaf to read.

Why, you might ask, is network marketing law like reading tea leaves? The reason is because the "law" that the FTC enforces regarding what constitutes an illegal pyramid scheme is not written in any book, and is not even explained, except in the most opaque manner, in the existing case law. *See, e.g.*, *FTC v. BurnLounge*, 753 F.3d 878 (9th Cir. 2014); *United States v. Gold Unlimited, Inc.*, 177 F.3d 472 (6th Cir. 1999); *Webster v. Omnitrition Int'l.*, 79 F.3d 776 (9th Cir. 1996).

Rather than asking Congress to enact uniform legislation which would define, in clear and certain terms, what constitutes an illegal pyramid, the FTC has steadfastly opposed efforts by the DSA and other interested parties to enact a federal anti-pyramiding statute. Rather than support a "bright line" test which would allow responsible companies to design a compensation system within the confines of the law, the FTC instead is unwilling to relinquish the virtually unlimited discretion accorded to it by Section 5(a) of the Federal Trade Commission Act which, without amplification, simply prohibits "unfair or deceptive acts or practices in or affecting [interstate] commerce." (Notably, the recently retired FTC pyramid expert, economist Peter Vander Nat has changed his position, and now supports a uniform federal rule (*http://tinyurl.com/vandernat-federal-pyramid-rule*).

So without a clear statute delineating the line between legal and illegal conduct, and with only a small handful of appellate court decisions which are often specific to the facts and compensation systems at hand, the next best resource available to figure out the FTC's view of the law is the small number of settlements negotiated at arms-length between network marketing companies and the agency.

Of course, until Vemma, the most recent and famous of these settlements was the July 2016 consent decree entered into between the FTC and Herbalife. That settlement, which took over a year to negotiate and was the subject of intense lobbying and public scrutiny, outlined, for the very first time, a set of parameters which, if followed, would be deemed by the FTC to constitute a "legal" multilevel marketing compensation system. (During the BurnLounge trial, FTC expert economist Vander Nat refused to identify any multilevel marketing company located anywhere in the world which he had determined to NOT be an illegal pyramid.)

Much has been written about the Herbalife settlement, which is quite intricate and contains detailed rules and formulas addressing subjects such as: the differentiation between preferred customers and participants in the business opportunity, and the importance of a company's clearly distinguishing between the two; limitations on the amount of compensation that can be paid attributable to the purchase of products by a participant (initially set at no more than $200 of wholesale expenditures per month), but not to exceed one-third of the participant's personal and downline volume) ("Allowable Personal Consumption"); a prohibition against using a participant's personal consumption to qualify to receive compensation, and a global company-wide restriction that at least 80% of product sales must be a combination of purchases by non-participants and Allowable Personal Consumption (failing which, commissions need to be reduced, on a company-wide basis, proportionately). The Herbalife settlement also, notoriously, prohibits auto-shipments, and assessed a $200 million monetary fine against the company.

© Lawrence B. Steinberg, Buchalter Nemer (2016)

Once the Herbalife settlement was announced, the "conventional wisdom" among the "network marketing bar" has been that the terms of the Herbalife consent decree would be a template that the FTC would seek to impose against network marketing companies in future negotiations and enforcement actions. This was supposed even though the FTC has been forthright in its view that the agency will impose restrictions in the context of settlements that go beyond what the law requires (so-called "fencing-in" provisions), ostensibly "to protect the public from those who have demonstrated an unwillingness to follow the law (*http://tinyurl.com/FTC-Staff-Advisory-Opinion*).

Comparing the Herbalife and Vemma settlement orders both proves and disproves the conventional wisdom:

- Both orders have important themes in common that all network marketing companies with an MLM compensation system should consider: the importance of distinguishing between true customers and business opportunity participants (and avoiding the temptation to categorize all constituents as business opportunity participants); the importance of having a system in place to track true retail sales and legitimate personal consumption; the high risk nature of allowing a participant to use his or her personal consumption of products to "qualify" for compensation; the necessity of educating a company's distributor base with respect to not over-selling the business opportunity; and the importance to monitor the field and, where appropriate and necessary, discipline those who run afoul of policies prohibiting income claims.

- The two settlements also announce, loudly and clearly, that the FTC remains suspicious of personal consumption, notwithstanding the clear statement in the 2004 FTC Staff Advisory Opinion that there is nothing *per se* illegal with rewarding personal consumption (*http://tinyurl.com/FTC-Staff-Advisory-Opinion*) and the Ninth Circuit's decision in the BurnLounge case to the same effect ("BurnLounge is correct that when participants bought packages in part for internal consumption . . ., the participants were the 'ultimate users' of the merchandise and that this internal sale alone does not make BurnLounge a pyramid scheme"; *http://tinyurl.com/BurnLounge-9th-Circuit-opinion*).

- On the other hand, a comparison of the Herbalife and Vemma settlement decrees demonstrates that the FTC does not have a single template or magic formula. Under the Herbalife settlement, it is permissible to pay a participant compensation for volume that includes personal consumption, but no more than $200 per month, and no more than one-third of the volume of the participant's downline. Under the Vemma settlement, if personal consumption constitutes more than 50% of a participant's compensable sales volume, no compensation at all can be paid to such a participant. Herbalife is prohibited from allowing its participants (but not its customers) from participating in any auto-shipment program; Vemma is under no such restriction. Herbalife was assessed a very substantial monetary penalty; Vemma, because it apparently made a showing of limited financial resources, has been ordered to pay a more modest fine. Herbalife must require all business participants to satisfy certain training requirements before it pays compensation to the participant; the Vemma decree contains no such training requirement.

CONCLUSION

© Lawrence B. Steinberg, Buchalter Nemer (2016)

There are important lessons to learn and consistent themes, in this latest settlement negotiated by the FTC. Unlike all enforcement actions that preceded Herbalife (Fortune Hi-Tech, BurnLounge, and Trek Alliance just to name a few), it appears that the Federal Trade Commission is finally beginning to recognize that there is a form of network marketing which is legal, and which is here to stay.

© Lawrence B. Steinberg, Buchalter Nemer (2016)