Herbalife: Belgian Appeal Court:
Herbalife is No Pyramid: Validates Legitimacy
The Next Chapter in Recognition of Personal Use

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Like the pine trees lining the winding road, I got a name… Jim Croce

And That Name Is Not "Pyramid"

So says a Belgian Appeal Court about American direct selling/network marketing company, Herbalife, a company with thousands of distributors in more than 80 countries.

In a ruling, December 2, 2013, the Court of Appeal in Brussels, came down like a sledge hammer on a lower court ruling of November, 2011 by the Brussels Commercial Court.** (*Test-Aankoop v. Herbalife International Belgium NV*, A.R. 2004/7787). The Appeal Court categorically reversed a lower court finding that Herbalife was a pyramid. To the contrary, it found the company to be in compliance with Belgian law and non-binding guidance that it referenced from the European Directive on direct selling.

**See a translated copy of the actual Belgian Court of Appeal *Herbalife* ruling.

Although a European court ruling, the core issue of "recognition of validity of personal use by direct selling distributors" has dominated discussion about the legitimacy of direct selling companies in the U.S. and internationally for two decades, and the import of this case and its discussion cannot be underestimated in its potential impact on future U.S. and international cases which distinguish legitimate direct selling from pyramid schemes.

The Belgian Lawsuit and the Lower Court Ruling

Based on a lawsuit brought by a nonprofit group, Test-Aankoop, in 2004, the lower court held Herbalife to be violative of Belgian law prohibiting pyramid schemes, the WMPC, the Belgian Law on Unfair Commercial Practices. The applicable pyramid law, as described by the Belgian Court of Appeal is as follows:

> *Article 91, 14° of the WMPC (Law of April 6, 2010, on market practices and consumer protection) provides that under all circumstances the following commercial practice shall be regarded as unfair:*
>
> *establishing, managing or promoting a pyramid scheme in which a consumer or an enterprise, after payment, is likely to receive a compensation that is derived primarily from the introduction of new consumers in the scheme rather than from the sale or consumption of products.*

Herbalife argued that many downline distributors joined Herbalife to purchase product for personal use and, therefore, were end consumers. However, the lower court rejected that purchases by Herbalife downline distributors for personal use should be recognized as sales to end consumers, opining that they were really just merchants purchasing within the sales force system, and therefore Herbalife violated Belgian law and was a pyramid.

Rejecting that distributor purchases could constitute sales to end consumers, the lower court dismissed the Herbalife explanation of its system:

> *Contrary to what Herbalife contends, it has not been proven that the distributors sell to end consumers.*

And that was the end of the story… at least for the lower court.

The Belgian Appeal Court: Herbalife Is Not a Pyramid

After a two-year appeal period, the Belgian Court of Appeal ruled that the lower court had it "all wrong." The Appeal Court ruling was unequivocal and unambiguous that Herbalife is a legitimate direct selling/network marketing/multilevel marketing business and that it is not a pyramid.

At the core of the decision was the Court of Appeal's recognition of the legitimacy of personal use by distributors as a legitimate destination for product and basis for payment of direct sales commissions and indirect or override commissions on purchases by downline distributors.

A fundamental finding by the Court of Appeal was that commissions were, in fact, paid on product destined for end consumers, even if some of those consumers were distributors themselves. And the Court found that product, which was not sold to customers or used, was subject to return or buyback and that Herbalife adopted a clawback or reversal of commissions on returned product to make sure commissions were not paid on product that was not sold to customers or used by distributors. In other words, all product was accounted for, either as resold to customers, used for personal use or returned to the company, subject to a "clawback" of commissions.

As a result, the Court of Appeal held that the lower court was wrong in holding that commissions were not paid on sale or consumption of product. At several points in its decision, the Belgian Appeal Court reiterated multiple times its finding that "personal use" of product by distributors is a legitimate destination for product and payment of commissions:

> *The law requires therefore that it is not a question of own sales, so that the circumstance that the compensation is obtained on the grounds of the sale of products by other participants in the network, namely 'downline' distributors, does not form any infringement of the legal provision.*
>
> *Nor does the law stipulate that the compensation may be obtained only from sales to a consumer who is not a distributor.*
>
> *As far as use is concerned, finally, the law does not stipulate that it is a question of the use by a non-distributor.*

Under such circumstances it cannot be argued that the system of the appellant makes it possible that her products wander about endlessly and never find their way to the consumer. All products that are bought by a distributor from the appellant, are either resold to a consumer, or are used by himself, or are returned by him to the appellant.

A distributor who sponsors may also obtain indirect profit from the sales or from own use of these products by means of his/her 'downline.' Also this indirect profit, which is subject to a quid pro quo, must be considered a compensation that comes from the sale or use of products as referred to in Articles 91, 14° and 99 of the WMPC. The obtaining of this compensation and therefore the possibility to obtain this form of indirect profit does not therefore indicate the existence of the forbidden pyramid system.

Consequently, it cannot therefore be claimed that it is a question of the forbidden pyramid sales for the reason that the distributor could obtain additional profit from the indirect distribution of profit, 'royalty overrides' and production bonuses, calculated on the sale of products by the distributors ranked below him/her in the network, rather than from the direct sales to consumers. As such, it is not forbidden for a distributor to aim for a network that is as broad as possible of 'downliners' in order to make as much profit as possible, as long as he/she is compensated on the basis of the purchase of products for selling on or for own use and not merely on the basis of the recruitment of new distributors.

From all previous determinations and considerations, it follows that it has not been shown that the sales system employed by the appellant can be considered as a system whereby the consumer/an enterprise, by means of a payment, receives a chance to a compensation which mainly flows from the establishment of new consumers/new enterprises in the system, than from the sale or consumption of products.

In conclusion, no infringement is shown to article 91, 14°, nor to article 99 of the WMPC.

Some Other Applause by the Court of Appeals for the Herbalife Business

Although the holding on "recognition of personal use" is at the core of the Belgian Appeal Court decision, the Court went on to note several salutary observations of Herbalife's business:

1. *From market research, which the appellant has carried out in August 2012 in Belgium, it showed that only 8% of the consumers of Herbalife were also distributors thereof. This shows that these products most definitely are being sold to ordinary consumers and are not only bought and sold within the system, and contradicts that they wander around endlessly within the system.*

2. *According to the figures communicated by Appellant, that are not contested, 85% of the distributors decide not to sponsor and opt therefore to sell the products directly to third parties or use them themselves.*

3. *From the aforementioned market study, it also shows that more than 50% of the respondents have already heard about the brand name Herbalife, and that 87% of the respondent have not bought any Herbalife products and that 88% of those who have already used the products, are of*

the intention to keep buying and using these products. Furthermore it concerns products that are used on a regular basis and not goods that are bought only once. As a result, as the number of buyers of these products increases, the demand for additional products will also increase.

4. The Court also noted that Herbalife has adopted and implemented the famous "Amway" consumer safeguard rules for its Supervisor-level distributors, which have been recognized over three decades of court cases, offering a buyback of product from terminating distributors, and providing a condition for receipt of commissions that those Supervisor-level distributors sell at least 70% of purchased product and have made monthly sales to each of ten customers.

5. The Court pointed out avoidance of an inventory loading incentive by implementing a "clawback" of upline commissions for returned product.

6. The opinion observed the offering of an entry level business kit and ongoing administrative fees that are commercially justified in price by the value provided, such that the payments are not to be viewed as "fees" for the right to recruit.

7. It noted that distributors are not mandated to buy product on an ongoing basis.

8. In addition the Court remarked on the lack of complaints: *"Moreover, the respondent fails to submit any kind of documentation from which it would show that a Belgian distributor has filed a complaint about the alleged fact that he was being stuck with too largean inventory of products."*

The Next Chapter in Personal Use

The issue of recognition of distributor personal use, and its impact on legitimacy, has ebbed and flowed for two decades, since the 1990's.

In fact, the Belgian lower court's rejection of personal use and its decision that Herbalife was a pyramid, was an evidentiary poster child for hedge fund short sale critics who claimed, in 2012, that Herbalife stock was destined to be valueless. Obviously, the Appeal Court decision might require some rethinking on this point.

The Belgian Appeal Court decision seems to continue a legal trend toward recognition of personal use in legal cases which differentiate legitimate direct selling from pyramid schemes. The original precedent discussion of "end user" in pyramid cases dates to a 1975 FTC ruling involving a cosmetics company named Koscot, where it appeared that distributors were loaded with inventory and taught to find other distributors to do the same. *In re Koscot Interplanetary Inc*, 86 F.T.C. 1106 (1975). The program was held to be a pyramid. The *Koscot* analysis test for pyramid schemes (which is not that significantly different than the Belgian law in the *Herbalife* case) is that pyramid schemes: "*are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users."*

A cloud over the direct selling industry appeared when a gratuitous statement in a 1996 Ninth Circuit U.S. Court of Appeals decision, *Webster v. Omnitrition*, 79 F.3d 776, called into question whether sales

to distributors should fulfill the *Koscot* standard of sales to ultimate users, i.e., perhaps only sales to non-distributor retail customers should count, as opposed to personal use by distributors.

Industry observers observed that the *Omnitrition* comment should not be accorded "weight" as the statement was "dicta" (unnecessary to reach the decision) and that the case was really about whether or not Omnitrition implemented safeguards to avoid "inventory loading" which were so clear that a trial would be necessary to determine Omnitrition was not a pyramid. (In reality, the decision did not involve a review of the merits of a trial court decision, but rather an appeal of a summary judgment in favor of Omnitrition.) Nevertheless, the language in *Omnitrition* created confusion in enforcement, in cases and in discussions by the legal and financial press. On various occasions and in various cases, the FTC argued that "personal use" should be excluded in a pyramid analysis, and that only sales outside the sales network should be considered, for purposes of pyramid vs. legitimate.

To address this confusion, more than a dozen states amended pyramid legislation to recognize the validity of personal use as an end destination of product. And the FTC issued a 2004 Advisory Opinion which accepted personal use in direct selling companies:

> *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.*

Notwithstanding this clarification, and court reasoning in opinions in several subsequent cases (*WholeLiving*, *BurnLounge*) the FTC, from time to time, offered inconsistent positions about personal use in briefs and proposed judgment orders. So, some real confusion continues. And this confusion, in addition to the Belgian lower court decision, was exploited by short seller hedge funds in their criticism of the direct selling industry.

The industry continues to look for clarity both in court cases and even possible remedial legislation along the lines of legislation adopted by many states. For this reason, every court case becomes important. And for this reason, the unambiguous statements of the Belgian Court of Appeal in the *Herbalife* case, cannot be underestimated.

Although the *Koscot* test (sales to the ultimate user) and the Belgian Court of Appeal analysis of its statute (product does not wander endlessly in the distributor system, but, in fact makes its way to the consumer) are not necessarily identical, the issues explored are so strikingly similar that the Belgian case will likely be cited as precedent in U.S cases on the subject of recognition of the role of personal use in pyramid analysis.

In fact, the discussion here appears to come full circle to the original analysis in the 1979 famous landmark Amway case. Amway has traditionally recognized personal use of product for commission purposes and the FTC Amway decision specifically recognized what it meant by sales to the "ultimate user" in terms similar to the Belgian court's reference to the "end consumer":

"….This multilevel wholesaling network ends with those distributors who have not sponsored any new distributors, and ***who make purchases from their sponsors solely for their own use or for resale to consumers****…….(emphasis added)*

…..Specifically, the Amway Plan is not a plan where participants purchase the right to earn profits by recruiting other participants, who themselves are interested in recruitment fees rather than the sale of products."

The Potential Impact of the Belgian *Herbalife* Decision May be Very Significant.

In fact, the *Herbalife* Belgian Court of Appeal's Ruling may well represent the next chapter in the court decisions on the issue of the validity of recognizing personal use as an end destination for product and for the basis of commissions for direct selling companies.

The Belgian Court will undoubtedly be cited in future court cases in Europe in that the Belgian law is pursuant to the European Directive's definition of a pyramid scheme; that directive calls for full harmonization under which every country in the EU is required to adopt the same terminology. As a result, this decision will be precedent throughout the EU as to how these statutes, in each member country, should be applied.

In addition, the decision will likely be cited in U.S. cases where a central issue continues to be recognition of personal use by the sales force. It will also likely be recognized as probative by regulatory enforcement agencies and legislative bodies as the issue of pyramiding is addressed. And, of course, it will be cited in the financial press on the issue of the legitimacy of the direct selling industry model, a discussion that involves billions of dollars by investors in publicly traded direct selling companies.

For more information on this subject and other important issues in the area of MLM, Direct Selling and Network Marketing, please visit http://www.mlmlegal.com.

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