

## The Success By Health (*FTC v. Noland*) Decision and Its Impact on the Direct Sales Industry

JUNE 1, 2023

A federal judge in Arizona recently rendered a [131-page order](#) setting forth his findings of fact and conclusions of law following an 11-day bench trial, explaining why he believed that the Federal Trade Commission (FTC) had proven that defendants Success By Health (SBH) and various related entities and individuals had engaged in a pyramid scheme, made false income claims, and committed various other violations of the FTC Act. SBH's conduct was particularly egregious and far out of step with best practices in the direct selling industry. That said, the court's analysis of SBH's conduct contained many sweeping statements that the FTC has already begun—and will certainly continue—to wield as a sword against legitimate direct sellers.

Here, we discuss key takeaways from the decision, as well as actions your company can take to avoid becoming the FTC's next target.

### The *Noland* Decision

The primary issue in *Noland* was whether SBH operated as an illegal pyramid scheme. The court applied the two-pronged *Koscot* “pyramid-scheme test,” characterizing an illegal pyramid scheme as any business model that requires participants to pay the business for (1) the right to sell a product and for (2) the right to receive rewards—unrelated to the sale of product—for the recruitment of others into the program.

SBH did not dispute that the first prong was satisfied and instead focused its defense on the second element. But the defense fell short, and the court found that “the evidence . . . overwhelmingly establishe[d] that the second prong of the pyramid-scheme test is satisfied.” The court cited six reasons in support of its conclusion:

- First, SBH paid commissions to its independent sales agents (known as “affiliates”) based on purchases affiliates made from SBH, rather than direct sales or re-sales to end users. The court was unpersuaded by the defendants' arguments that affiliate purchases from SBH were a “proxy” for retail sales, finding instead that “[d]efendants 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 (e., to ‘duplicate’).”
- Second, the court reviewed SBH's marketing materials, presentations, and social-media posts and noted that SBH focused primarily on recruiting and very little on retail sales to consumers. The court acknowledged that the

defendants' materials made occasional cursory mentions of retail sales but determined that such passing references did not indicate that retail sales were a major focus of the business. **Notably, the court held that SBH inhibited retail sales by prohibiting affiliates from selling via outlets such as Amazon and eBay and by barring affiliates from selling products below the suggested retail price.**

- Third, the court noted that after SBH was placed into receivership following an earlier court order and the receiver eliminated the then-existing commission structure, the company experienced a 95% reduction in product sales. That “staggering” figure signaled to the court 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.”
- Fourth, the court was persuaded by evidence showing (1) **a spike of SBH product purchases on the last day of the month**; (2) that 95% of SBH products were purchased by affiliates; and (3) that “SBH affiliates were economically incentivized (and aggressively encouraged) to use monthly purchases to maintain the ‘rank’ necessary to qualify for increased commissions.”
- Fifth, the court criticized the improbability that an SBH affiliate could earn a “significant source of income” from retail sales. For example, the defendants’ first witness— whom they “held [ ] up as an example of the legitimacy of SBH as a business opportunity”—earned about \$2,500 in profit (in both commissions and net retail re-sales) while working “full-time on SBH” for around two years; the judge called this “a damning indictment of SBH.” And other witnesses called by the defendants at trial actually lost money.
- Sixth, the court found that several of SBH’s business practices were indicative of a pyramid scheme, including that it failed to track affiliates’ retail sales, did not implement adequate safeguards against inventory loading, adopted a no-refunds policy, and required (or strongly encouraged) monthly auto-orders.

The court also found that the defendants made misleading income claims in violation of the FTC Act’s prohibition on unfair or deceptive acts. The court stated that “the net impression created by Defendants’ advertisements was that affiliates could reasonably expect to earn substantial, if not life-changing, amounts of money if they followed Defendants’ instructions.” The court expressly criticized the defendants for telling affiliates they could expect to obtain “financial freedom” in 18 months. The court found that the defendants’ use of disclaimers (e.g., that income representations were “theoretical examples” and were not guaranteed) did not render the claims not misleading. And the court further found that by giving affiliates materials that contained false and misleading representations, the defendants were liable for furnishing the “means and instrumentalities” for the commission of deceptive acts by affiliates.

And, somewhat troublingly, the court liberally referenced the testimony of the FTC’s expert, Stacey Bosley, without explaining any of her opinions in detail, tying them to the specific facts of the case, or setting forth why the court found her opinions to be credible. The court’s apparent uncritical acceptance of Bosley’s testimony opens the door for the FTC and plaintiffs’ attorneys to present Bosley’s opinions against direct sellers in the future. Indeed, the FTC has used Bosley as an expert in numerous actions against direct sellers and is currently relying on her expert opinion in asserting that Neora operates a pyramid scheme.

### **How the FTC Is Using—and Will Continue to Use—the Decision**

Just five days after the *Noland* decision, the FTC cited Judge Lanza’s order in a Notice of Supplemental Authority in its ongoing litigation against Neora, a direct-selling business that markets supplements, skin creams, and other health and wellness products. The FTC alleges that Neora, like SBH, made representations that affiliates could dramatically increase their income, using phrases such as “lifestyle-changing income” and “Significant Earning Potential,” while the average active Neora affiliate allegedly earned only \$65 annually. The FTC’s filing highlighted the perceived similarities between SBH and Neora and touted Judge Lanza’s credibility findings with respect to Bosley.

There can be no doubt that the FTC will continue to wield the *Noland* decision against other direct sellers. The easiest way for the FTC to identify the next company to target is to scour social media or other public sources (such as consumer “watchdog” websites or blogs by disgruntled former MLM distributors) as well as by reviewing the

policies and procedures of direct selling companies. Although companies cannot directly control what others will say about them online, removing “red flags” from company policies, web advertisements, and marketing materials is one of the most important steps direct sellers can take to avoid becoming the FTC’s next target. Below we have provided numerous examples of such “red flags” your company should be considering.

### **Actions Your Company Can Take to Reduce Exposure**

The following are examples of actions your company can take now to greatly reduce your chances of becoming the FTC’s next target for alleged pyramid scheme and deceptive acts claims:

- Review your company’s marketing materials and eliminate any potentially misleading income or lifestyle claims.
- Publish an accurate and effective income disclosure statement that reflects the experience of a typical participant and instruct your distributors how they must use it.
- Review your company’s compensation plan and eliminate recruitment-based incentives and promotions in favor of rewards driven by end-user sales.
- Consider removing perceived “impediments” to retail sales, such as restricting sales via online and in-person marketplaces and prohibiting distributors from setting their own resale prices (within reasonable limits to prevent compensation plan manipulation).
- Track retail sales.
- Prohibit distributors from utilizing auto-ship.
- Implement a “true undo” return policy.
- Create incentives for consumers who are not interested in the business opportunity to enroll as “preferred customers” (or similar title) rather than distributors
- Analyze your business intelligence data to determine whether there are any “red flags” in your compensation plan—e.g., threshold-based rewards, convex rewards, or duplication incentives.
- Audit your company’s compliance functions to ensure that they are adequately monitoring and remediating compensation plan manipulation, misleading income, lifestyle, or product statements, and other potential misconduct.

Winston has extensive experience advising companies in all these areas. We help our direct sales clients minimize exposure from claims by governmental authorities and private plaintiffs. We are able to immediately assist if the FTC or a plaintiff’s attorney comes calling—but we strongly prefer advising our clients on reforms that, if taken now, will greatly reduce the risk of expensive and burdensome litigation later.

Finally, our colleagues at The Brattle Group have assessed *Noland* from an expert economist’s perspective and proposed various business modifications direct sellers should consider. If you would like a copy of Brattle’s article, please reach out to us.

*Winston & Strawn Summer Associate Matthew Alan Reilly also contributed to this blog post.*

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