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BLOG

Neora Part I: The Decision and Its Implications

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THE DECISION AND ITS IMPLICATIONS

In a long-awaited decision, last week Judge Barbara Lynn in the United States District Court for the Northern District of Texas granted Neora, LLC (formerly, Nerium) a victory, denying every single claim the FTC brought, including the FTC's argument that Neora was operating an illegal pyramid scheme and made deceptive income and product claims. In the 56-page decision, Judge Lynn weighed the evidence presented at trial and provided meaningful guidance as to how and why Neora satisfied important safe harbors from FTC action. The court rejected many of the theories the FTC argued constituted hallmarks of a pyramid scheme. And the court agreed with Neora that many of its policies and procedures demonstrated it was operating a legitimate direct-sales organization.

In a series of blogs on lessons learned from *Neora*, we'll outline the evidence presented in the Neora case, the parties' arguments, the court's rulings, and the lessons that the industry can learn from them. This first article captures the reasoning underlying the court's decision that Neora is not operating a pyramid scheme and the evidence the court relied on in reaching that decision. Next, we'll tackle the court's decision that Neora did not make false claims and is not responsible for any false claims its distributors might have made. And then we'll provide a series of articles detailing lessons learned that your company could use to reduce its exposure to enforcement actions in the future.

BRIEF BACKGROUND

The FTC filed suit in November 2019 against Neora and others, alleging five violations of the FTC Act: (1) operation of an illegal pyramid scheme, (2) false earning claims, (3) false efficacy claims, (4) false establishment claims, and (5) means and instrumentalities. The FTC originally sought monetary damages and injunctive relief under section 13(b) of the FTC Act. However, the court dismissed the FTC's claims for monetary damages following the Supreme Court's 2021 *AMG* Capital decision, which forecloses the FTC from obtaining monetary redress through section 13(b). As a result, at the week-long trial held in October 2022, Judge Lynn considered only whether the FTC was entitled to injunctive relief. On September 28, 2023, the court denied "all of Plaintiff Federal Trade Commission's requests for relief . . . , including its request for injunctive relief."

THE STANDARD: *KOSCOT*

In 1974, the FTC established a test for what constitutes a pyramid scheme in *In re Koscot Interplanetary, Inc., et al.* The *Koscot* test has two elements: (1) participants must pay money to the company in return for the right to sell a product, and (2) participants must pay money to the company in return for the right to receive rewards that are unrelated to the sale of product to ultimate users, in exchange for recruiting other participants into the program. Both elements must be met for a company to be operating a pyramid scheme. However, the test has not been formally adopted by all the federal circuits.

The second part of the *Koscot* test (whether rewards are unrelated to the sale of product to ultimate users) is typically the disputed issue. But, in recent years, the FTC has moved away from its own test, arguing that there are many hallmarks of a pyramid scheme that can exist even in companies whose rewards are all tied to the sale of product to ultimate users. For example, the FTC has argued that auto-shipping, minimum monthly qualifying volume requirements, and sales from one distributor to another are all problematic even in companies that compensate distributors only when product sales are involved.

In *Neora*, Judge Lynn discussed the history of the *Koscot* test and noted that it had not been formally adopted by the Fifth Circuit. The court then went on to apply the test to the facts presented in the case. The court quickly found the first question was satisfied because Neora participants, called "Brand Partners" or "BPs," are required to buy a $20 enrollment kit. Accordingly, the court's focus turned to the second question, which the court recognized as the "*sine qua non* of a pyramid scheme"—did Neora BPs receive rewards for recruiting other participants, unrelated to the sale of product to ultimate users? The court explained that "the primary focus in deciding whether a business is a pyramids scheme is whether the business focuses exclusively or almost exclusively on *recruiting* as opposed to *sales*."

THE COURT'S ANALYSIS

The court began its inquiry by reviewing Neora's compensation plan, but rejected the FTC's argument that the compensation plan should be viewed in isolation. Accordingly, the court considered other factors alongside the compensation plan to show "how the business operates in practice."

The court began by stating that Neora's rewards based entirely on sales to end users, including "Preferred Customers" or "PCs," were unproblematic. All other rewards, the court confirmed, "require some recruitment element" because they require the BP to have recruited at least three active BPs. Indeed, the court assumed that the rights to receive those rewards "are earned by BPs in exchange for recruiting other participants in the program." So, as the court posed, the question became **whether those rewards are unrelated to the sale of the product to ultimate users**.

The court rejected the opinion of the FTC's favorite (and much-used) expert witness, Dr. Stacie Bosley, who assumed that purchases by BPs cannot be considered sales to end users because such purchases can only be attributed to a desire to participate in the business opportunity. This assumption, the court found, was not supported by the evidence. At trial, Neora presented evidence that many BPs enrolled solely for product discounts that are only available to BPs, intending to consume the product rather than reselling it. For example, Neora presented surveys showing that some BPs reported their top reason for enrolling was to receive discounts on the product. Neora also presented data showing that, in 2021, 30% of newly enrolled BPs had converted from being Preferred Customers. The court found this to be compelling evidence that at least some BPs were end users seeking to consume the product for a discount. Thus, the FTC's argument that the majority of Neora's BPs lose money fell flat. As the court analogized, "we may 'walk away poorer than we started' after a trip to the grocery store, but because we obtained valuable goods or services in return for our money, that exchange is not characterized as a loss." With the rejection of Dr. Bosely's assumptions, the FTC's case for a pyramid scheme was deflated.

The court criticized the FTC's failure to present evidence to support its position that BP purchasing motivations are based on the compensation plan. However, the court did not bar the door for such arguments in the future, noting "evidence the FTC could have provided . . . which could have supported its position." For example, the court suggested that evidence that BPs consistently purchased product at a reward-qualifying volume (particularly at the end of a qualifying period) could have turned the tables on Neora, as such evidence would demonstrate that BPs purchased the product to qualify for the rewards or participate under the compensation plan.

WHAT'S NEXT IN THE FTC'S BATTLE AGAINST DIRECT SELLERS?

Direct sellers have been operating under a shroud of uncertainty for decades, attempting to ascertain what line differentiates lawful and unlawful conduct. Judge Lynn's rejection of many of the FTC's theories as to what constitutes a pyramid scheme goes a long way in providing much-needed guidance to legitimate direct sellers. The court's rejection of the FTC expert's opinion that sales to distributors cannot constitute sales to end users is an important win. So too was the court's acceptance of Neora's contention that not all BPs sign up to earn compensation. Both issues have been hotly contested between the industry and the FTC. The fact that the court accepted the industry's contentions will certainly be helpful going forward.

However, some in the industry might take the ruling as some sort of panacea that cures all uncertainty and that, so long as rewards are tied to sales, a company is operating lawfully. But we urge caution. A close reading of the opinion makes clear that the decision could have gone the other way if Neora did not have data and other evidence to demonstrate that it operated a legitimate business in practice. Furthermore, it is unclear what appeals the FTC may bring, whether the FTC may file suit in other jurisdictions it deems more favorable, or whether the FTC will continue to experiment with other weapons in its arsenal, such as its rule-making authority. But one thing is for certain: Judge Lynn's opinion provides a framework that direct sellers can use to help reduce their exposure to pyramid-scheme claims in the future.

And on that note, stay tuned for our multipart series on the numerous lessons that can be learned from *Neora* and the changes that your company can implement to better protect itself from FTC enforcement actions.

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John Sanders, Jr.

Katrina Eash

Jackson C. Smith

Ashley Wright

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