A critical examination of Herbalife's business model in order to determine whether it is a prohibited scheme under the Consumer Protection Act 68 of 2008

by

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DECLARATION

I, Johara Deen Ally, hereby declare that this dissertation, unless specifically indicated otherwise, is my own work and that all references have been properly made. This dissertation has not been submitted to any other university in full or partial fulfilment of the academic requirements of any other degree or qualifications.

Signed at Durban on the 28th day of January 2019.

Signature: [signature]
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ABSTRACT

Herbalife is an international direct selling company involved in the production, promotion and sales of a variety of nutritional products including those designed to assist with weight management and personal care. The company has frequently come under legal scrutiny, most recently in the United States of America where it was the subject of a Federal Trade Commission (FTC) investigation. Herbalife shareholders alleged that Herbalife International of America, Inc., Herbalife International, Inc., and Herbalife, Ltd. (the Herbalife companies) were operating like an illegal pyramid scheme rather than like a legitimate multi-level marketing (MLM) company which it purported to be.

Pyramid schemes can take different forms and sizes but all share certain common characteristics. The main feature of these schemes is that distributors are primarily compensated for the introduction of new recruits rather than for actual retail sales. The problem with this is that there are a finite number of human beings to recruit and such schemes cannot sustain themselves. It is for this reason that pyramid schemes are mathematically improbable hence unlawful.

The FTC investigation concluded that Herbalife was not a pyramid scheme but required that the company make certain changes to its business model and prove, going forward, that its business model is sustainable. This dissertation examines whether Herbalife’s business model amounts to a prohibited scheme under the Consumer Protection Act 68 of 2008. This issue will be analysed particularly through the lens of section 43 of the Act. To help better understand the legal stance on pyramid schemes, pyramid schemes will be viewed in comparison with legitimate MLM firms such as Avon Products Inc. and Tupperware Brands Corporation. In addition, the Herbalife business model will also be viewed in light of other sections of the CPA which proscribes certain conduct.
CHAPTER 1
INTRODUCTION

1.1 Background
Herbalife is an international direct-selling company that sells a range of products including those dealing with weight management and nutrition. The company sells products to its members who buy the product for either personal use or for resale to other members whom they have recruited. Herbalife also sponsors many athletes, professional teams and leagues as well a few National Olympic Committees, the likes of which include Portuguese soccer player Cristiano Ronaldo and soccer team Los Angeles Galaxy.¹

Herbalife has frequently come under legal scrutiny. Many people believe that Herbalife is a scam because it operates in a pyramid-like manner. However, others are of the view that Herbalife is a legitimate network marketing company. The manner in which Herbalife operates is what led to the allegations in the United States of America that Herbalife is an illegal pyramid scheme. However, following an investigation by the Federal Trade Commission (FTC), it was concluded that the company was not in fact an illegal pyramid scheme.² The Commission did, however, require Herbalife to make changes to its business practices and called on Herbalife to prove, going forward, that its business model is sustainable.³ Despite questions about Herbalife and its business model, no South African authority such as the Department of Trade and Industry (DTI) or the National Consumer Commission (NCC)⁴ has investigated these allegations.

¹ Kaki ‘Does celebrity endorsements have the potential to transform a brand?’ 1 August 2016 available at https://mpk73t22016clusterb.wordpress.com/2016/08/01/does-celebrity-endorsements-have-the-potential-to-transform-a-brand/ (accessed on 17 May 2018). Information about Herbalife celebrity endorsements can also be found on the Herbalife website available at http://company.herbalife.com/sponsorships/ (accessed on 17 May 2018).
³ Ibid.
⁴ The NCC is an organ of state assigned with the task of ensuring enforcement of the CPA. The NCC and its role will be further discussed in Chapter 3.
In 2003, Woker wrote that pyramid schemes were on the rise in South Africa with more people falling victim to these schemes every day.\(^5\) She also pointed out that South Africa’s past, together with poverty and a high unemployment rate, creates a ‘fertile breeding ground for opportunists’.\(^6\) In 2009, the Consumer Protection Act 68 of 2008 (hereinafter referred to as the CPA) was passed as law.\(^7\) The Act deals specifically with pyramid and other unlawful schemes yet it seems that South Africa continues to provide a fertile ground for those who wish to promote unlawful schemes. In 2016, the South African Reserve Bank (SARB) investigated 27 money scams. The Bank Supervision Department’s annual report revealed that 19 of these schemes had been carried over from previous years whilst the other eight were new.\(^8\)

The old adage ‘if it sounds too good to be true it probably is' probably best describes pyramid schemes. Promoters entice people to join the scheme with false promises of making a lot of money. Consumers gravitate toward these schemes because of greed or gullibility. Hoexter JA said the following with regard to pyramid schemes:

‘History. . . teaches us that in the human breast greed and gullibility are often partners. It is on these twin weaknesses that all confidence-tricksters trade; and not a few flourish’.\(^9\)

These schemes appear on the face of it to be more lucrative investment opportunities as opposed to conventional methods of investment.\(^10\) Consumers are attracted by the possibility of obtaining instant wealth and acquiring possessions such as lavish cars and houses, all while exercising minimal effort.\(^11\)

Pyramid schemes were recognised as a problem in South Africa long before the inception of the CPA. In 1980, conditions were imposed on the operation of these and other similar schemes by the DTI.\(^12\) This was followed by regulations adopted under

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\(^6\) Ibid 238.

\(^7\) Melville The Consumer Protection Act made easy 2 ed (2011) 1.


\(^9\) Commissioner for Inland Revenue v Insolvent Estate Botha t/a ‘Trio Kulture’ 1990 (2) SA 548 (A) at 554D – E.


\(^12\) Reg 469 of GG 6880 14/3/1980.
the Harmful Business Practices Act 71 of 1988 (this Act was later renamed the Consumer Affairs (Unfair Business Practices Act)).

The Harmful Business Practices Act was established to enable the Harmful Business Practices Committee (subsequently renamed the Consumer Affairs Committee) (‘the Committee’) to investigate harmful business practices. The Committee, following an investigation, could then make recommendations to the Minister of Trade and Industry.¹³ In some instances, the Minister would issue regulations which regulated the business practices to ensure that they did not harm consumers and in other instances, the Minister closed the business down completely, declaring it to be a harmful business practice.¹⁴

At first the Committee investigated individual businesses which were subsequently declared to be harmful pyramid and other similar type schemes.¹⁵ Two businesses that were investigated by the Committee were Rainbow Business Club and Newport Business Club (Pty) Ltd.¹⁶ The Committee then conducted a general investigation into pyramid schemes, money multiplication schemes and chain letters which identified the hallmarks of such unlawful schemes.¹⁷ The Minister then issued regulations declaring that pyramid schemes, money multiplication schemes and chain letters were harmful business practices and that it was a criminal offence to participate in such a scheme.¹⁸

Those regulations where then incorporated into the CPA namely in section 43(2)(b) and section 43(4)(a).

1.2 Statement of purpose

The purpose of this dissertation is to critically examine how Herbalife operates in South Africa and to determine whether or not Herbalife is contravening South African legislation on pyramid schemes.

¹³ Woker ‘Why the need for consumer protection legislation? A look at some of the reasons behind the promulgation of the National Credit Act and the Consumer Protection Act’ (2010) 31(2) Obiter 220.
¹⁴ Ibid 219-220.
¹⁵ Woker ‘If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds’ 2003 15 SA Mercantile Law Journal 240.
¹⁶ GN 1134 of 20169 9/6/1999 5.
¹⁸ Ibid.
In order to fulfil the purpose, section 43 of the CPA will be analysed and pyramid schemes will be compared and contrasted with legitimate multi-level marketing programmes such as Avon Products Inc. and Tupperware Brands Corporation.

1.3 Rationale

Although the CPA came into operation eight years ago, in 2011, many people are still unaware that participating in pyramid schemes is illegal.\(^\text{19}\) Pyramid schemes continue to operate in South Africa.\(^\text{20}\) These schemes take on many forms and sizes and each one can differ from the next.\(^\text{21}\) However, the common thread among pyramid schemes is that a few participants benefit at the expense of the majority of the participants. Those at the bottom of the pyramid often find themselves losing their investments. Promoters usually disappear without a trace, leaving participants with no means of recourse and no way to recoup their investment.\(^\text{22}\)

Herbalife is a successful business that operates throughout the world. The company operates in over 90 countries across the Americas, Europe, the Middle East, Africa and Asia Pacific.\(^\text{23}\) It began in South Africa in 1995 where it continues to operate.\(^\text{24}\) However, Herbalife is often criticised for being a pyramid scheme and has been investigated in a number of different countries, most notably the United States of America where it has been the subject of an FTC investigation.\(^\text{25}\) Even in South Africa there have been allegations that Herbalife is an unlawful pyramid scheme.

\(^{19}\) Joroy 4440 CC v Potgieter 2016 (3) SA 465 (FB).


\(^{23}\) Information regarding Herbalife is available on its website http://www.herbalife.com/global (accessed on 12th April 2018).


Nevertheless, South Africans are still involved in Herbalife and, should it be found that the company is in fact a pyramid scheme, its members could lose their investment.

The reason behind this dissertation is to determine whether or not Herbalife is a pyramid scheme under South African law thereby educating people who wish to join the company.

1.4. Research questions
This study intends to answer the following questions:
1. What is a pyramid scheme and how can such schemes be identified?
2. What is multi-level marketing and to what extent does legitimate multi-level marketing differ from a pyramid scheme?
3. What is the South African law on pyramid schemes?
4. What is Herbalife and how does it operate?
5. How does the United States of America view Herbalife?

1.5. Methodology
This research paper is solely desktop-based. Information is drawn mainly from textbooks, journal articles, government publications and internet sources. The CPA and other legislation will also be considered.

1.6. Structure of the dissertation
Chapter 1 provides an introduction to this mini-dissertation setting out the background to the topic followed by the statement of purpose and rationale. The research questions which will be answered in this dissertation are then listed and the research methodology which will be adopted is discussed. The chapter concludes with the structure of this dissertation.
Chapter 2 discusses the concepts of pyramid scheme and multi-level marketing and distinguishes between the two. This chapter will focus, in particular, on the hallmarks of a pyramid scheme.

The focus of Chapter 3 is on the law governing pyramid schemes in South Africa. A brief history of the law will precede a critical examination of section 43 of the CPA. This chapter also includes an analysis of other relevant sections of the CPA. The chapter concludes with a brief discussion of the common law concept of fraud.

Chapter 4 discusses Herbalife’s business model. The chapter will analyse the allegations that Herbalife operates as a pyramid scheme and will consider the investigation that took place in the United States, following which Herbalife was found not to be a pyramid scheme but it was required to make certain changes and to give certain assurances. A synopsis of the current allegations against Herbalife, in the United States, is also contained in this chapter.

Chapter 5 looks at and examines Herbalife from a South African legal perspective.

Chapter 6 concludes the study and contains recommendations for Herbalife.
CHAPTER 2
PYRAMID SCHEMES AND MULTI-LEVEL MARKETING

2.1 Introduction
During the 1990s, the number of pyramid schemes rapidly increased,26 as did the international growth of multi-level marketing.27 It is sometimes difficult to distinguish between an illegal pyramid scheme and a legitimate multi-level marketing programme.28 This chapter will explain the term pyramid scheme, differentiate between promotional and product-based schemes, discuss how pyramid schemes can be identified and consider the problems associated with these schemes. This discussion will be followed by an analysis of what constitutes multi-level marketing, the ‘legal cousin’ of pyramid schemes.29 To better illustrate the concept of multi-level marketing, legitimate companies such as Avon Products Inc (Avon) and Tupperware Brands Corporation (Tupperware) will be considered. The chapter concludes with a test to help determine whether or not a particular scheme is a pyramid scheme.

2.2 Pyramid schemes
2.2.1 Hallmarks of a pyramid scheme
Pyramid schemes can be diverse in nature but all pyramid schemes share common characteristics. These hallmarks can assist in identifying whether or not an investment opportunity is a legitimate business opportunity or a pyramid scheme. Where a pyramid scheme is involved, there are either no products or services for sale or those that are being sold have little or no value for the consumer.30 Promoters of the scheme

also engage in false advertising regarding how valuable the product is,\textsuperscript{31} for example, they purport to sell miracle creams.\textsuperscript{32} Products are usually overpriced and incidental to the business opportunity.\textsuperscript{33} Distributors are encouraged to purchase large quantities of goods up-front and there is often no repurchase scheme for unsold goods.\textsuperscript{34}

Another tell-tale sign of a pyramid scheme is a complex commission structure. A complex commission structure is cause for concern when products or services are not sold to people outside the organisation.\textsuperscript{35} Schemes are also promoted as a get-rich-quick investment with promoters falsifying or exaggerating financial figures and potential earnings.\textsuperscript{36}

Pyramid schemes are composed of various levels comprising a pyramid structure and those at the bottom of the pyramid benefit only after those at the top.\textsuperscript{37} Furthermore, (and possibly the main feature of a pyramid scheme) income is derived principally from the recruitment of new investors into the scheme with actual retail sales contributing minimally to a distributor’s earnings.\textsuperscript{38} This is sometimes known as a head-hunting fee.\textsuperscript{39}

Upon joining the scheme, members are required to make an investment.\textsuperscript{40} This is referred to as a joining fee.\textsuperscript{41} In order to recoup one’s own investment, a participant in a scheme needs to canvass new members who need to canvass new members and

\begin{thebibliography}{99}
\bibitem{31} Ibid.
\bibitem{32} Majola and Dini ‘All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers’ 15 July 2015 available at https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351 (accessed on 21 February 2018).
\bibitem{33} This feature of a pyramid scheme is discussed on the Facts About Herbalife website available at https://www.factsaboutherbalife.com/the-facts/the-herbalife-pyramid-scheme/ (accessed on 8 November 2018).
\bibitem{35} This feature of a pyramid scheme is discussed on the Facts About Herbalife website available at https://www.factsaboutherbalife.com/the-facts/the-herbalife-compensation-plan/ (accessed on 8 November 2018).
\bibitem{38} Ibid.
\bibitem{40} Nhlapo ‘We’re Still Falling For Ponzi And Pyramid Schemes’ 9 March 2018 available at https://www.huffingtonpost.co.za/2018/03/09/we-are-still-falling-for-ponzi-and-pyramid-schemes_a_23381530/ (accessed on 31 August 2018).
\bibitem{41} Albaum and Peterson ‘Multilevel (network) marketing: an objective view’ \textit{The Marketing Review} (2011) 11(4) 352.
\end{thebibliography}
The following very basic example illustrates how this works: the founder of a pyramid scheme recruits five members, each of whom have to pay R500 to join the scheme. They are then in turn required to recruit five other members each of whom pays R500. Provided they are able to recruit five members each, the first five recruits will each earn R2000 in profit.

Again, assuming that the initial five recruits each recruit five more people, those 25 new recruits need to each recruit five others in order to make R2000. Thus, there needs to be 125 new willing participants. Those at the subsequent level then need to sign up a further 725 people in order to generate a profit. Thus, the number of participants required for each new level to make a profit increases as the levels increase.

Pyramid schemes are dependent on a constant inflow of new participants, a situation which is mathematically improbable because ‘there is a finite number of human beings to recruit’. The longer a scheme is in existence, the harder it is to find new members. Inevitably, there will come a time when there is an insufficient number of new recruits and the scheme cannot sustain itself. The scheme will collapse ‘when the inflow of funds no longer sustain[s] the outflow of extravagant returns to participants’. Consequently, the majority of investors are financially at a loss and unable to recoup their investment.

In summary, pyramid schemes are fraudulent business ventures that mislead consumers as to the true nature of the scheme. In promoting the scheme, the

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46 Fourie NO & Others v Edeling NO & Others 2005 (4) All SA 393 (SCA).
organisers misrepresent potential earnings to potential recruits. Organisers misrepresent potential earnings to potential recruits. Recruits are led to believe that financial success is attainable by participating in these schemes, however, it is usually only those at the top of the pyramid, such as the initial organisers, who are enriched.

2.2.2 Promotional pyramid schemes and product-based pyramid schemes

Pyramid schemes can be divided into two categories namely, promotional pyramid schemes and product-based pyramid schemes. Promotional pyramid schemes (also known as investment-based or naked pyramid schemes) invite potential investors to join an organisation or club. Meetings are held during which investors are convinced to pay forward a sum of money to the promoter, money which can be recovered through recruiting more members. Because compensation is based solely on recruitment, promotional pyramid schemes are described as wealth transfer schemes and are generally regarded as illegal, fraudulent schemes. The FTC also classified these schemes as an unfair and deceptive practice. These were the original pyramid type schemes and it was because they were generally regarded as fraudulent (thus illegal) that promoters of such schemes started to evolve their schemes into schemes that sold products.

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Product-based pyramid schemes involve the selling of a product or service.\textsuperscript{59} However, sales are usually only made internally (to those within the organisation) or to new recruits.\textsuperscript{60}

These schemes are complex and exist in multiple forms. In addition to recruiting others, distributors may be required to pay fees and/or purchase products or services up front or compensation could be calculated based on recruitment, with actual retail sales mostly or completely excluded from the equation.\textsuperscript{61}

The problem with product-based schemes is that they misrepresent to recruits and potential recruits the income that can be expected. As stated by Keep and Vander Nat, ‘all [product-based schemes] claimed income levels well above what could realistically be achieved’.\textsuperscript{62} An additional problem is that distributors often end up with products they are unable to sell or return,\textsuperscript{63} products which in most cases have little to no value.\textsuperscript{64}

The introduction of products in pyramid schemes makes it difficult to distinguish between an illegal pyramid scheme and a legitimate MLM programme. However, even in schemes where there is a product involved, the primary focus is still on recruitment. Investors join the scheme with the intention of generating a profit and not because they believe in the product being sold.\textsuperscript{65} The product is of insignificant value to the consumer,\textsuperscript{66} and is used to detract from the fact that the business venture is a pyramid scheme.\textsuperscript{67}

\textsuperscript{63} Ibid 140-141.
\textsuperscript{64} Woker ‘Section 43’ in Naude and Eiselen (eds) Commentary on the Consumer Protection Act (Original Service 2014) para 20.
\textsuperscript{65} Ibid.
\textsuperscript{66} Ibid.
2.3 Multi-level marketing

2.3.1 What is multi-level marketing?

Multi-level marketing (MLM) is a legitimate form of direct selling,\(^{68}\) or retail distribution,\(^{69}\) which began in the 1940s.\(^{70}\) It is also known as network marketing, relationships selling and multi-level direct selling.\(^{71}\) It is an alternative business model\(^{72}\) suitable for entrepreneurs who are financially ill-equipped to start their own business or join a franchise because in most cases they are joining an already established business.\(^{73}\) Participants usually join MLM firms because of its associated benefits which include being able to work from home and work flexible hours whilst earning an income or supplementing their income.\(^{74}\)

MLM programmes are legal provided compensation is not derived primarily through recruitment. Furthermore, the firm must offer a tangible product or service to the public,\(^{75}\) ‘without requiring these consumers to pay anything extra or to join the MLM system’.\(^{76}\) Most MLM firms offer a variety of products and/or services,\(^{77}\) which, unlike pyramid schemes, have real value to purchasers.\(^{78}\) Product distribution usually takes place face-to-face with registered independent distributors meeting customers in

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\(^{68}\) Woker ‘Section 43’ in Naude and Eiselen (eds) *Commentary on the Consumer Protection Act* (Original Service 2014) para 19.

\(^{69}\) Coughlan ‘FAQs on MLM Companies’ July 2012 available at [http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf](http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf) (accessed on 22 May 2018).


\(^{73}\) Coughlan ‘FAQs on MLM Companies’ July 2012 available at [http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf](http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf) (accessed on 22 May 2018).


\(^{78}\) Woker ‘Section 43’ in Naude and Eiselen (eds) *Commentary on the Consumer Protection Act* (Original Service 2014) para 21.
person.\textsuperscript{79} Sales can be done door-to-door, on a party plan basis (product parties) or may even be concluded telephonically.\textsuperscript{80} Different MLM programmes have different compensation plans,\textsuperscript{81} however, distributors are generally compensated for their own retail sales (the compensation value being the difference between retail price and cost price) as well as the sales concluded by members in their downline (that is, their direct and indirect recruits).\textsuperscript{82} A distributor’s own sales includes products purchased for personal consumption, a concept known as internal consumption.\textsuperscript{83} In addition, MLM marketers may sometimes receive commission for bringing in new recruits. This blurs the line between pyramid schemes and MLM firms but in the case of MLM, this commission is permitted in terms of the Direct Marketing Code of Conduct.\textsuperscript{84}

Distributors have a symbiotic relationship with their respective MLM companies.\textsuperscript{85} One of the functions of an MLM firm is to provide a product or service that is then sold by its distributors.\textsuperscript{86} The distributor may take on a dual role operating as both salesperson and sales manager.\textsuperscript{87} Being a salesperson requires, \textit{inter alia}, informing consumers about the products and/or services and enabling them to purchase these, should they so wish. The role of a sales manager, on the other hand, involves recruiting others wanting to join the firm, helping them register as distributors and training them in

\begin{thebibliography}{1}
\bibitem{80} Woker ‘Section 43’ in Naude and Eiselen (eds) \textit{Commentary on the Consumer Protection Act} (Original Service 2014) para 19.
\bibitem{82} Coughlan ‘FAQs on MLM Companies’ July 2012 available at http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf (accessed on 22 May 2018).
\bibitem{84} Woker ‘If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds’ (2003) 15 \textit{SA Mercantile Law Journal} 243.
\bibitem{85} Coughlan ‘FAQs on MLM Companies’ July 2012 available at http://www.kellogg.northwestern.edu/faculty/coughlan/htm/personalpage_files/Papers/FAQs%20on%20MLM%20Companies%207-30-2012%20FINAL.pdf (accessed on 22 May 2018).
\bibitem{86} Ibid.
\bibitem{87} Ibid.
\end{thebibliography}
preparation for this role.\textsuperscript{88} The success of an MLM firm is dependent on the contributions of the distributors and the firm itself.\textsuperscript{89}

The structure of MLM firms also differ and may comprise of a single level or multiple levels. The number of levels is, however, generally limited and not indefinite as is the case with pyramid schemes.\textsuperscript{90}

\subsection*{2.3.2 Examples of MLM firms}

MLM firms vary considerably and span numerous different industries.\textsuperscript{91} Examples of well-known MLM firms include Avon and Tupperware.

Avon is an international company that operates in the cosmetic industry.\textsuperscript{92} The company offers a range of products such as makeup, perfumes and jewellery.\textsuperscript{93} An Avon representative can earn commission in various ways.\textsuperscript{94} Firstly, through face-to-face product sales. The amount of commission received depends on the order size but ranges from 20 to 40\%. However, when a representative reaches a certain level (known as President’s Club) they can earn up to 50\%.\textsuperscript{95} Secondly, commission can be earned via online sales (through a distributor’s personal Avon website) or a combination of face-to-face and online sales. Lastly, commission can be earned through leadership. Leadership involves recruiting others (essentially forming a downline) who then begin their own Avon businesses.\textsuperscript{96} There are different stages involved in the leadership programmes such as Advanced Unit Leader and Avon

\textsuperscript{88} Ibid.
\textsuperscript{89} Ibid.
\textsuperscript{90} Albaum and Peterson ‘Multilevel (network) marketing: an objective view’ \textit{The Marketing Review} (2011) 11(4) 351.
\textsuperscript{93} Ibid.
\textsuperscript{94} Information about the different ways an Avon representative can earn commission can be found on the Makeup Marketing Online website accessible on http://www.makeupmarketingonline.com/can-you-make-money-selling-avon/ (accessed on 22 July 2018).
\textsuperscript{95} Information on the different levels of commission in the Avon compensation structure can be found on the Makeup Marketing Online website available at http://www.sellingbeautyonline.com/avon-commission-chart-2018/ (accessed on 22 July 2018).
\textsuperscript{96} Information about the different ways an Avon representative can earn commission can be found on the Makeup Marketing Online website accessible on http://www.makeupmarketingonline.com/can-you-make-money-selling-avon/ (accessed on 22 July 2018).
Executive Leader. A representative’s progress is determined by the number of recruits in his or her downline.

Tupperware is an internationally recognised brand that principally sells homeware, particularly kitchenware. In addition, the company sells beauty products by brands such as Avroy Shlain and BeautiControl. The various types of commission a Tupperware representative can earn are as follows: retail sales commission whereby distributors earn 25% commission on the products they have sold, bonuses on sales which are awarded to representatives who exceed a certain sales volume and lastly, commission on team performance which is awarded to managers and directors.

There are different levels through which a Tupperware representative can transcend. The first is the level of a consultant who earns income from personal sales, second is a manager whose income is based on personal sales and total team sales, third is a team leader whose income is calculated on personal sales, total team sales as well as sales of the group and finally, at the apex is the level of distributor whose income is based on organisation sales.

As can be seen from the above two compensation plans, members in a legitimate MLM firm are primarily compensated through retail sales and not through the recruitment of new participants into the selling plan.

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98 Ibid.
100 Ibid.
102 Information of Tupperware’s business model can be found on the Tupperware Brand’s website available at https://ir.tupperwarebrands.com/investor-story/business-model.
2.3.3 Criticisms of MLM

The MLM model is not without criticism. There are those who oppose the idea claiming that all forms of MLM should be prohibited and not just pyramid schemes. Critics argue that MLM programmes are unethical in that distributors pressurise friends and relatives to purchase the firm’s products, ‘inflate earning claims during recruiting’ and ‘sell under the pretext of a party’. However, despite these criticisms, MLM remains a legitimate means of direct selling.

2.4 Pyramid schemes versus MLM

Although all pyramid schemes are MLM companies, not all MLM companies are illegal pyramid schemes. To help distinguish between the two, Albaum and Peterson have established a four-question test, the answers to which will determine whether or not an organisation is a pyramid scheme. Firstly, one must identify the product or service that is being sold. Is it an actual product or service or merely ‘the right to sell a product or service’? Secondly, the joining fee needs to be considered. Is the amount that a participant is required to pay upon entering the organisation fair and reasonable? Is it proportionate to what the participant receives in return? Thirdly, is there inventory loading? Inventory loading is the practice whereby a company pressurises recruits to purchase products, often more products than which they are capable of selling. Finally, does the MLM company have a buyback policy? That is, will the company buy back the unsold stock of a distributor who wishes to exit the company, thereby enabling the distributor to recoup some of their money?

107 Ibid.
company does not force recruits to purchase products and has a buyback policy, then 
the company in question is not a pyramid scheme.110

2.5 Conclusion

Pyramid schemes and MLM are two distinct concepts but are often confused because 
of their similar hierarchical structure. The differences, however, lie in how they operate. 
The key feature of a pyramid scheme is that compensation is primarily derived through 
recruitment. Although MLM firms may sometimes compensate its members for 
recruiting others, this is not the primary source of compensation. MLM firms are more 
retail-focused with members predominantly generating an income from the sale of 
products and/or services offered by the firm. These products and services have real 
value to the consumer, unlike those which some pyramid schemes purport to sell. In 
addition, pyramid schemes often require its participants to pay unreasonable joining 
fees, pressurise them into buying products and do not cater for inventory buyback 
when a distributor wishes to leave the business.

MLM programmes provide a legitimate business opportunity for those wanting to earn 
an income whilst a pyramid scheme is merely ‘a money-transfer scheme in which the 
foreseen losses of the vast majority become winnings for a small minority at the top of 
the recruitment structure.’111 The continuous cycle of taking from Peter to pay Paul is 
unsustainable and mathematically improbable, given that there are a finite number of 
human beings to recruit.112 Thus, whilst MLM companies are legitimate, pyramid 
schemes remain unlawful. The next chapter will deal with the South African law on 
pyramid schemes.

111 Keep and Vander Nat ‘Multilevel Marketing and Pyramid Schemes in the United States: An Historical 
112 Krige ‘Fields of Dreams, Fields of Schemes: Ponzi Finance and Multi-level Marketing in South Africa’ 
CHAPTER 3
PYRAMID SCHEMES AND THE LAW IN SOUTH AFRICA

3.1 Introduction

To help combat the problem of pyramid schemes discussed in Chapter 2, the South African government first introduced conditions regulating pyramid schemes.\(^{113}\) However, these regulations were regarded as being cumbersome and no reported decisions based on these regulations appear to exist.\(^{114}\) The legislature subsequently enacted legislation governing pyramid schemes. The two main pieces of legislation in this regard are the Harmful Business Practices Act (renamed the Consumer Affairs (Unfair Business Practices) Act) and the CPA.\(^{115}\) Both these Acts will be considered in this Chapter with the focus being on the CPA and section 43 in particular. Other relevant sections of the CPA will also be discussed, followed by a brief discussion of the common law position on fraud.


The purpose of this Act was to prohibit or control certain business practices.\(^{116}\) The Act was first introduced in 1988 and was then amended significantly in 1999. Before the amendments, the Act dealt with harmful business practices, but the Amendment Act widened the scope of the Act by introducing the concept of an unfair business practice. Hence, it was no longer necessary to show that a particular business practice was harmful, it was only necessary to show that the business practice was unfair to

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\(^{113}\) Woker ‘If it Sounds too Good to be True it probably Is: Pyramid Schemes and other related Frauds’ (2003) 15 SA Mercantile Law Journal 238.

\(^{114}\) Ibid.

\(^{115}\) Other pieces of legislation regarding pyramid schemes include the Banks Act 94 of 1990 and the Financial Advisory and Intermediary Services Act (FAIS) 37 of 2002. These pieces of legislation relate to pyramid schemes because the Banks Act regulates the taking of money from the general public and the FAIS Act regulates the giving of financial advice. A discussion of these aspects of pyramid schemes is beyond the scope of this mini-dissertation therefore, this dissertation will only deal with the Harmful Business Practices Act (Consumer Affairs (Unfair Business Practices) Act)) and the CPA.

\(^{116}\) Department of Trade and Industry ‘Presentation on Consumer Protection’ available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).
consumers. Section 1 of the Amendment Act defines an unfair business practice (previously termed a harmful business practice)\textsuperscript{117} as

‘any business practice which, directly or indirectly, has or is likely to have the effect of –

(a) harming the relations between businesses and consumers;

(b) unreasonably prejudicing any consumer;

(c) deceiving any consumer; or

(d) unfairly affecting any consumer’.

To help fulfil its purpose, the Act established the Business Practices Committee (which under the Amendment Act was renamed the Consumer Affairs Committee (CAFCOM)).

The Consumer Affairs (Unfair Business Practices) Act was a piece of enabling legislation conferring certain powers upon CAFCOM. This included powers to conduct investigations.\textsuperscript{118} The National Office of Consumer Protection (OCP) acted on behalf of CAFCOM and was empowered to conduct investigations (both formal and informal) into alleged unfair business practices.\textsuperscript{119} Investigators required CAFCOM’s approval in order to conduct a section 4 (informal) or section 8 (formal) investigation.\textsuperscript{120} Section 4(1)(c) of the Act provided for preliminary investigations. These investigations were informal and the details were not revealed publicly.\textsuperscript{121} These investigations were conducted when it was believed that there was a harmful business practice or there was a possibility that one could arise.\textsuperscript{122} The purpose of such investigation was to determine how the business in question operated,\textsuperscript{123} and to establish whether there was a need for a section 8(1)(a) investigation to be concluded.\textsuperscript{124} If the results of the investigation confirmed the existence or potential existence of an unfair business

\textsuperscript{117} Janse van Rensburg and Another v Minister of Trade and Industry and Another (CCT13/99) [2000] ZACC 18 at paragraph 9.
\textsuperscript{118} GN 2967 of GG 27125, 20/12/2004, 9.
\textsuperscript{119} Department of Trade and Industry ‘Presentation on Consumer Protection’ available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).
\textsuperscript{120} Ibid.
\textsuperscript{121} GN 2967 of GG 27125, 20/12/2004, 9.
\textsuperscript{122} GN 1134 of 20169 9/6/1999 4-5.
\textsuperscript{123} GN 2967 of GG 27125, 20/12/2004, 9.
\textsuperscript{124} GN 1134 of 20169 9/6/1999, 5.
practice, the OCP would convey this to CAFCOM. As per section 9 of the Act, CAFCOM had the option of negotiating with any person or entity in order to try and reach an arrangement wherein the offending party agreed to stop engaging in the unfair conduct. If, however, CAFCOM’s attempts at negotiation were unsuccessful, a section 8(1)(a) investigation could ensue. A section 4(1)(c) investigation was not, however, mandatory. If *prima facie* evidence suggested that an unfair business practice was being conducted, the Committee could forgo the section 4(1)(c) investigation and immediately pursue a section 8(1)(a) investigation.

Unlike section 4(1)(c) investigations, section 8(1)(a) investigations were formal and notice thereof had to be published in the *Government Gazette*. Section 8(1)(a) investigations were also known as particular investigations because the allegedly unfair business practices of particular entities, or unfair business practices which could arise in future, were the subject of the investigation. Section 8(1)(b) made provision for formal investigations that were more general in nature. In terms of this section, ‘any business practice being applied by persons in general for the purposes of creating or maintaining a harmful business practice’ could be investigated.

These investigations were conducted either because the Committee took the initiative, upon receipt of a complaint by the public, or if the Committee received an instruction from the Minister of Trade and Industry because the Minister believed there was a need to conduct such an investigation.

A key difference between both the section 8 investigations is that orders made in respect of section 8(1)(a) investigations applied only to those whose business practices had been investigated while Ministerial orders made in response to section

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126 Ibid.
127 GN 188 of GG 34174, 31/03/2011, 7
8(1)(b) investigations applied to all those who were guilty of engaging in the particular practice that was investigated.\(^{133}\)

A host of general and specific investigations were conducted over a number of years.\(^{134}\) Ultimately, the Committee concluded that there were three main types of schemes which had the potential to cause harm to consumers: pyramid promotional schemes, money revolving schemes and chain letters.\(^{135}\) These schemes were declared to be harmful business practices by the Minister.\(^{136}\) Both the act of establishing and participating in a pyramid scheme was prohibited.\(^{137}\) If compensation from a scheme was not derived from the services the scheme offered or the products it sold, this was contrary to the Consumer Affairs (Unfair Business Practices) Act. Any person who was convicted of promoting or participating in such a scheme could be subject to a penalty not exceeding R200 000 and/or imprisonment for no longer than two years.\(^{138}\)

CAFCOM presented reports to the Minister following which the Minister could issue a notice in the Government Gazette suspending the practice pending the finalisation of the investigation.\(^{139}\) If the Committee found that a practice was unfair, it made recommendations to the Minister who had various powers under section 12 of the Act. The Minister, after consideration of those recommendations, could elect to either accept or reject the recommendations.\(^{140}\) If the Minister chose to accept the recommendations, an order was published in the Government Gazette.\(^{141}\) The Minister could declare a practice unlawful if it was unfair or contrary to the interest of the public.\(^{142}\) Furthermore, the Minister could direct any person to refrain from


\(^{134}\) For an example of a specific investigation see the investigation into the business practices of Zhauns Group of Companies in GN 188 of GG 34174, 31/03/2011. For an example of a general investigation see GN 469 of GG 28691, 30/03/2006.


\(^{136}\) Ibid.

\(^{137}\) Department of Trade and Industry ‘Presentation on Consumer Protection’ available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).

\(^{138}\) Ibid.

\(^{139}\) Ibid.

\(^{140}\) Ibid.

\(^{141}\) Ibid.

\(^{142}\) Department of Trade and Industry ‘Presentation on Consumer Protection’ available at media.withtank.com/6adcc510b8.ppt (accessed on 16 August 2018).
perpetuating the practice directly or indirectly.\textsuperscript{143} The Minister’s power to order that an unfair business practice be stopped could, however, only be exercised after a section 8(1)(a) investigation and not after a preliminary investigation.\textsuperscript{144} Decisions made by the Minister could be appealed by those affected.\textsuperscript{145}

As can be seen from the above discussion, CAFCOM’s power was limited to just investigation and recommendations. CAFCOM itself could not order any redress for consumers who had been harmed by any business practices. If there was a breach of the Minister’s orders, the matter had to be referred to the South African Police Service (SAPS) and the National Prosecuting Authority (NPA).\textsuperscript{146} However, consumer issues were often neglected by these authorities as there were (and still are) more pressing criminal issues that warranted the attention of these enforcement agencies.\textsuperscript{147}

The Consumer Affairs (Unfair Business Practices) Act was the forerunner to the CPA.\textsuperscript{148} Although the CPA repealed and replaced this Act,\textsuperscript{149} it has influenced the contents of the CPA.\textsuperscript{150} The discussion above therefore provides a useful context to section 43 of the CPA which now governs pyramid schemes.

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\textsuperscript{143} This includes ‘advertising, becoming a party to arrangements, deriving interest or income etc.’ Ibid.

\textsuperscript{144} GN 2967 of GG 27125, 20/12/2004, 9.

\textsuperscript{145} Department of Trade and Industry ‘Presentation on Consumer Protection’ available at media.witthank.com/6adcc510b8.ppt (accessed on 16 August 2018).

\textsuperscript{146} Woker ‘Why the need for consumer protection legislation? A look at some of the reasons behind the promulgation of the National Credit Act and the Consumer Protection Act’ (2010) 31(2) Obiter 220.

\textsuperscript{147} Ibid.


3.3 The CPA

3.3.1 Background

The CPA was signed into law on 24 April 2009, and came into effect on 31 March 2011. The CPA is an attempt to consolidate South African consumer law, and is regarded as ‘a single comprehensive legal framework for consumer protection’. It is a step toward bringing South African legislation in line with international consumer rights. The purposes of the CPA include protecting consumers from ‘deceptive, misleading, unfair or fraudulent conduct’, promoting fair business practices and prohibiting ‘certain unfair marketing and business practices’.

Chapter 2 contains eight fundamental rights which consumers have. Part F of Chapter 2 deals with a consumer’s right to fair and honest dealing. Section 43 (which covers pyramid and related schemes) falls under this part.

3.3.2 The CPA and pyramid schemes

The first important point to note about section 43 is that the schemes listed in section 43 are prohibited, not regulated. In other words, there are no prescribed requirements which, if complied with, will render the schemes lawful.

Section 43(2)(b) expressly prohibits pyramid schemes. The section reads as follows:

‘a person must not directly or indirectly promote, or knowingly join, enter or participate in –

... 

(b) a pyramid scheme, as described in subsection (4)

... 

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152 Joroy 4440 CC v Potgieter 2016 (3) SA 465 (FB).
157 Ibid.
158 As mentioned at the outset of the CPA.
or cause any other person to do so’.

The words ‘must not’ indicate that it is mandatory that persons abstain from becoming involved in pyramid schemes. The prohibition relates to both the participation in and promotion of a scheme. The first part of section 43(2)(b) ‘a person must not directly or indirectly promote, or knowingly join, enter or participate in…’ and the last part ‘or cause any other person to do so’ is regarded as the ‘required degree of involvement’ whilst a pyramid scheme (listed in paragraph (b)) will be the ‘identified activity’.160 Thus if a person has the required degree of involvement in relation to the identified activity (that is, if they promote, or knowingly join, enter or participate or cause another person to promote, knowingly join, enter or participate in a pyramid scheme) they will be guilty of engaging in prohibited conduct.

In terms of section 43(4) of the CPA,

‘an arrangement, agreement, practice or scheme is a pyramid scheme if—

(a) participants in the scheme receive compensation derived primarily from their respective recruitment of other persons as participants, rather than from the sale of any goods or services; or

(b) the emphasis in the promotion of the scheme indicates an arrangement or practice contemplated in paragraph (a).’

The CPA definition above is centred around the most notable hallmark of a pyramid scheme. That is, pyramid schemes are focussed on the recruitment of more participants in the scheme as opposed to retail sales.161

The terms ‘consideration’ and ‘participant’ used in relation to pyramid schemes are defined in section 43(1)(a) and (b) respectively.

The definition of consideration is the same as that contained in section 1 with a few exceptions.162 The term consideration excludes:

161 Woker ‘Section 43’ in Naude and Eiselen (eds) Commentary on the Consumer Protection Act (Original Service 2014) para 15.
162 Under section 1 the term consideration is defined as ‘anything of value given and accepted in exchange for goods or services, including— (a) money, property, a cheque or other negotiable instrument, a token, a ticket, electronic credit, credit, debit or electronic chip or similar object; (b) labour, barter or other goods or services; (c) loyalty credit or award, coupon or other right to assert a claim; or (d) any other thing, undertaking, promise, agreement or assurance, irrespective of its apparent or
‘(i) the purchase of any goods at cost to be used in making sales, or not for resale;

(ii) the purchase of any goods in exchange for which the seller of those goods offers to repurchase the participant’s products under reasonable commercial terms; and

(iii) the participant’s time and effort in pursuit of sales or recruiting activities’.\(^{163}\)

A participant is ‘a person who is admitted to a scheme for consideration’.\(^{164}\) Participation includes involvement as an organiser or promoter of a scheme, consumer involvement by way of joining the scheme as well as causing other persons to participate in the scheme.\(^{165}\) In pyramid schemes, the participative role of those involved often changes. People usually join the scheme as recruits and then they themselves become recruiters.\(^{166}\) Any form of participation in pyramid schemes is illegal and will constitute a breach of the CPA.\(^{167}\)

Other key terms employed in the definition of pyramid scheme are ‘goods’, ‘services’ and ‘promotion’.

The word ‘goods’ as defined in section 1 of the CPA includes:

‘(a) anything marketed for human consumption;

(b) any tangible object not otherwise contemplated in paragraph (a), including any medium on which anything is or may be written or encoded;

(c) any literature, music, photograph, motion picture, game, information, data, software, code or other intangible product written or encoded on any medium, or a licence to use any such intangible product;

\(^{163}\) Section 43(1)(a) of the CPA.

\(^{164}\) Section 43(1)(b) of the CPA.


\(^{166}\) Ibid.

(d) a legal interest in land or any other immovable property, other than an interest that falls within the definition of ‘service’ in this section; and

(e) gas, water and electricity’.\textsuperscript{168}

The definition of ‘service’ as contained in the Act can be summarised as

‘work performed by a person for the direct or indirect benefit of another; education, information, advice or consultation, banking or similar financial services,\textsuperscript{169} transportation of goods or an individual; provision of accommodation, entertainment or access to entertainment, access to electronic communication infrastructure, access or a right of access to an event, premises, activity or facility or access to or use of property in terms of a rental. Service also includes the right of occupancy of, or power or privilege over, land or immovable property, and the rights of a franchisee in terms of a franchise agreement provided for in the Act’.\textsuperscript{170}

The word ‘promote’ means to—

‘(a) advertise, display or offer to supply any goods or services in the ordinary course of business, to all or part of the public for consideration;

(b) make any representation in the ordinary course of business that could reasonably be inferred as expressing a willingness to supply any goods or services for consideration; or

(c) engage in any other conduct in the ordinary course of business that may reasonably be construed to be an inducement or attempted inducement to a person to engage in a transaction’.

It is presumed that when interpreting the meaning of the word ‘advertise’ as contained in paragraph (a) of the definition of ‘promote’, courts will look to the definition of

\textsuperscript{168} The term ‘goods’ encompasses a variety of items. Under the definition, ‘bread, compact discs (CDs), electronic appliances and books’ can be classified as goods. Havenga … et al \textit{General Principles of Commercial Law} 7 ed (2010) 486.

\textsuperscript{169} Excluded from the ambit of the definition of service are services or advice dealt with under the Financial Advisory and Intermediary Services Act 37 of 2002 or services covered under the Long-term Insurance Act 52 of 1998 or the Short-term Insurance Act 53 of 1998. The CPA is, however, applicable to the marketing of financial services. Ibid.

\textsuperscript{170} The term service is not confined to the activities listed above. Havenga … et al \textit{General Principles of Commercial Law} 7 ed (2010) 486.
advertisement provided in section 1 of the Act.\textsuperscript{171} The use of the verb ‘supply’ in paragraphs (a) and (b) when used ‘in relation to goods, includes sell, rent, exchange and hire in the ordinary course of business for consideration’\textsuperscript{172} and when used ‘in relation to services, means to sell the services, or to perform or cause them to be performed or provided, or to grant access to any premises, event, activity or facility in the ordinary course of business for consideration’\textsuperscript{173}

To promote a pyramid scheme is unlawful. Thus, if someone, in the ordinary course of business, advertises, displays, offers to supply or whose conduct indicates a willingness to supply, goods or services, for consideration, or induces or attempts to induce others to engage in the scheme, they will be guilty of unlawful conduct on the basis of promoting a prohibited scheme.

In addition to the schemes expressly classified in section 43 as being prohibited, section 43(2)(d) read with section 43(6) empowers the Minister of Trade and Industry to declare any arrangement, agreement, practice or scheme as prohibited if the purpose or effect of such scheme is similar to a scheme mentioned in section 43(2)(a)-(c), for example, a pyramid scheme.\textsuperscript{174} Participating in a scheme declared prohibited by the Minister is also unlawful.

### 3.3.3 Other relevant provisions

In addition to section 43, the CPA contains numerous other provisions prohibiting unfair marketing and business practices. The CPA also contains sections which aim to fulfil its goal of protecting consumers from ‘deceptive, misleading, unfair or fraudulent conduct’\textsuperscript{175} and to safeguard consumers against ‘unconscionable, unfair, unfair,
unreasonable, unjust or otherwise improper trade practices’. Sections 29, 40, and 41 are of particular relevance to this dissertation as well as sections 48, 51, 52 and 69 (insofar as it relates to sections 29, 40 or 41).

Section 29 addresses the general standards for the marketing of goods and services. According to section 29,

‘a producer, importer, distributor, retailer or service provider must not market any goods or services—

(a) in a manner that is reasonably likely to imply a false or misleading representation concerning those goods or services, as contemplated in section 41; or

(b) in a manner that is misleading, fraudulent or deceptive in any way ...

Subsection (b) goes on to list examples of marketing which may constitute misleading, fraudulent or deceptive conduct. It is apparent from subsection (a) that that provision has to be read with section 41.

As a whole, section 41 deals with the regulation of false, misleading or deceptive representations. Under section 51(1)(i), a supplier is prohibited from concluding a transaction or agreement if the ‘general purpose or effect [thereof] is to mislead or deceive the consumer’.

Section 41 reads as follows:

‘(1) In relation to the marketing of any goods or services, the supplier must not, by words or conduct—

(a) directly or indirectly express or imply a false, misleading or deceptive representation concerning a material fact to a consumer;

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176 Section 3(1)(d)(i).
178 This section echoes s4(5)(b) which states that ‘in any dealings with a consumer in the ordinary course of business, a person must not… engage in any conduct that is unconscionable, misleading or deceptive, or that is reasonably likely to mislead or deceive’.
(b) use exaggeration, innuendo or ambiguity as to a material fact, or fail to disclose a material fact if that failure amounts to a deception; or

(c) fail to correct an apparent misapprehension on the part of a consumer, amounting to a false, misleading or deceptive representation, or permit or require any other person to do so on behalf of the supplier.

(2) A person acting on behalf of a supplier of any goods or services must not—

(b) engage in any conduct that the supplier is prohibited from engaging in under subsection (1)’.

Subsection (3) provides a list of guidelines as to what can be regarded as a false, misleading or deceptive representation, however, this list is not exhaustive.\(^{179}\)

Section 41 is a codification of the common law and it places emphasis on procedural fairness in contracts. Section 41(1)(a)-(c) lists the factors which affect procedural fairness.\(^{180}\)

Section 41(2) indicates that it is not just the supplier who is prohibited from engaging in the conduct described in section 41(1). The prohibition also extends to any person acting on the supplier’s behalf.\(^{181}\)

Section 48 of the CPA deals with unfair, unreasonable or unjust contract terms. The relevant parts of that section are:

‘(1) A supplier must not—

(b) market any goods or services, or negotiate, enter into or administer a transaction or an agreement for the supply of any goods or services, in a manner that is unfair, unreasonable or unjust;

(2) Without limiting the generality of subsection (1), a transaction or agreement, a term or condition of a transaction or agreement, or a notice to which a term or condition is purportedly subject, is unfair, unreasonable or unjust if—

...(c) the consumer relied upon a false, misleading or deceptive representation, as contemplated in section 41 or a statement of opinion provided by or on behalf of the supplier, to the detriment of the consumer;

...’.

Thus, if a consumer relies on a false, misleading or deceptive representation conveyed by the supplier or by someone acting on the supplier’s behalf and that reliance negatively impacts the consumer, such a term or contract will be unfair, unreasonable or unjust.

With regard to the latter part of section 48(2)(c), a statement of opinion does not have to be false, misleading or deceptive to amount to an unfair term or contract. If a statement concerning a material fact ultimately caused detriment to the consumer, it can be declared as being unfair.\(^{182}\)

Section 40 of the CPA covers unconscionable conduct. In terms of this section,

‘(1) A supplier or an agent of the supplier must not use physical force against a consumer, coercion, undue influence, pressure, duress or harassment, unfair tactics or any other similar conduct, in connection with any—

(a) marketing of any goods or services;

(b) supply of goods or services to a consumer;

(c) negotiation, conclusion, execution or enforcement of an agreement to supply any goods or services to a consumer;

...

\(^{182}\) Ibid 1101.
In addition to any conduct contemplated in subsection (1), it is unconscionable for a supplier knowingly to take advantage of the fact that a consumer was substantially unable to protect the consumer’s own interests because of physical or mental disability, illiteracy, ignorance, inability to understand the language of an agreement, or any other similar factor.

Like section 41, section 40 is also concerned with procedural fairness, specifically, how consent was obtained. Section 40 deals with unconscionable conduct of a supplier or a supplier’s agent. It gives effect to the CPA’s aim to protect consumers from ‘unconscionable, unfair, unreasonable, unjust or otherwise improper trade practices’.

According to section 1 of the CPA, when the word unconscionable is used in relation to any conduct, it means ‘having a character contemplated in section 40; or otherwise unethical or improper to a degree that would shock the conscience of a reasonable person’. This definition is simplified by the DTI which states that ‘unconscionable conduct refers to behaviour that is unethical or improper’. According to Du Plessis, for conduct to be unconscionable, a substantial amount of impropriety must exist.

The scope of section 40 is quite broad because it applies not only to the listed conduct but to ‘any other similar conduct as well’. Thus unconscionable conduct may also include contractual negotiations which take place despite no serious or bona fide intention to conclude a contract, an abuse of one’s right to withdraw one’s offer and overlooking the fact that one might not be able to perform in future.

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184 Section 3(1)(d)(i).
Section 40(1) refers to a situation in which a consumer cannot exercise their will freely because of the conduct of the supplier or the supplier’s agent. This is regardless of whether or not the supplier or the agent engaged in the conduct knowingly.\textsuperscript{189}

It is necessary to understand each form of conduct stipulated in section 40(1) in order to understand what amounts to unconscionable conduct.\textsuperscript{190} Absolute force refers to physical force but could also encompass threats of physical force, however, this may be equivalent to coercion or duress.\textsuperscript{191} Where an agreement was concluded because of absolute force, the agreement will be void \textit{ab initio}.\textsuperscript{192}

Du Plessis points out that coercion is a foreign concept with no established definition in South African contract law.\textsuperscript{193} According to the \textit{Webster Comprehensive Dictionary}, coercion means ‘forcible constraint or restraint, moral or physical; compulsion’.\textsuperscript{194} Therefore Du Plessis argues that the word coercion is redundant because of the inclusion of the word duress which is a concept that is known in South African law.\textsuperscript{195} In the case of duress, it is acceptable for a person to have exercised their will. The focus here is on how fear was instilled, and consent obtained. Duress involves the use of unlawful threats to induce the conclusion of a contract.\textsuperscript{196}

Undue influence was defined in the case of \textit{Preller and Others v Jordaan}.\textsuperscript{197} It is essentially a situation in which one party acquires an influence over the other and such influence impairs the latter’s resistance with the result that they cannot exercise their own will.\textsuperscript{198} The influence is used to conclude a transaction that is to the weaker party’s


\textsuperscript{191} Du Plessis ‘Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008’ (2012) \textit{75 THRHR} 27.


\textsuperscript{195} Du Plessis ‘Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008’ (2012) \textit{75 THRHR} 27.

\textsuperscript{196} Ibid 29.

\textsuperscript{197} 1956 (1) SA 483 (A).

detriment and is a transaction that the weaker party would not have ordinarily consented to. Where undue influence is the cause of a contract, the contract is voidable at the election of the consumer.\footnote{199}{Jacob, Stoop and Van Niekerk 'Fundamental Consumer Rights Under the Consumer Protection Act 68 of 2008: A Critical Overview and Analysis' (2010) 13 (3) PER/PELJ 347.}

Du Plessis notes that suppliers exert ‘pressure’ on consumers in order to persuade them to act in a particular way.\footnote{200}{Du Plessis ‘Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008’ (2012) 75 THRHR 29.} Suppliers appeal to a customer’s insecurities and fears, however, these attempts by suppliers are usually harmless. Furthermore, it is difficult to determine when pressure will amount to unconscionable conduct that cannot be covered under any of the other section 40(1) grounds.\footnote{201}{Ibid.}


‘Tactic’ is defined as ‘an action or plan that is intended to achieve something’.\footnote{204}{Soanes (ed) South African Pocket Oxford Dictionary 3 ed (2006) 925.} ‘Unfair tactics’ indicates that that action or plan is unacceptable in some way. Unfair tactics could possibly include exploiting weak persons other than those covered by section 40(2).\footnote{205}{Du Plessis ‘Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008’ (2012) 75 THRHR 31.}

The forms of conduct discussed above are prohibited when marketing goods and services as well and when negotiating, concluding, executing or enforcing an agreement to supply goods and services to a consumer.\footnote{206}{Sections 40(1)(a) and 40(1)(c).}

With regard to section 40(2), if the consumer informs the supplier that they are unable to read the agreement or do not understand the language contained therein but the supplier proceeds to carry out the agreement, that is likely to be unconscionable.\footnote{207}{Du Plessis ‘Protecting consumers against unconscionable conduct: Section 40 of the Consumer Protection Act 68 of 2008’ (2012) 75 THRHR 34.}
This is because unlike section 40(1), under section 40(2) the supplier must have been aware of the weakness.

The same applies to ‘ignorance’. Ignorance could be a general lack of education on the part of the consumer or a lack of specific knowledge pertaining to the consumer’s interaction with the supplier.\(^{208}\)

It is suggested that ‘any other similar factor’ could encompass immaturity and inexperience which results in the consumer being generally unable to form a proper judgment.\(^{209}\)

According to the *Cambridge Online Dictionary*, to take advantage of someone means ‘to use someone’s weakness to improve your situation’.\(^{210}\) Thus, section 40(2) means that the supplier must have exploited the consumer’s weakness for the supplier’s benefit.

In order to ensure that section 40(2) is not contravened, a supplier must make certain that the agreement is understood by the relevant consumer and that the consumer is capable of protecting their interests.\(^{211}\)

Overall, section 40 emphasises that parties to an agreement ought to act in good faith and should abstain from engaging in improper or unconscionable conduct or conduct that is contrary to public policy.\(^{212}\) In cases where there has been unconscionable conduct, the avenues of recourse available in section 69 are applicable.\(^{213}\)

Both unconscionable conduct (section 40) and false, misleading or deceptive representations (section 41) are deemed prohibited conduct under the CPA.\(^{214}\) Thus, if it is concluded by the NCC that an arrangement, agreement, practice or scheme does not amount to a pyramid scheme, a consumer who suffered as a result thereof

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\(^{208}\) Ibid.

\(^{209}\) Ibid.


\(^{212}\) Ibid 1112 footnote 77.

\(^{213}\) These include approaching the NCT, an ombud with jurisdiction, an accredited industry ombud, a consumer court with jurisdiction, an alternative dispute resolution agent, the NCC or, as a last resort, a court with jurisdiction.

\(^{214}\) Section 51 of the CPA.
is not necessarily without recourse. If the perpetrators of a scheme or other arrangement acted in a manner that was unconscionable when marketing or negotiating an agreement with a consumer, or made false or misleading misrepresentations, the consumer may approach a civil court that has the power to ensure fair and just conduct, terms and conditions. If the court determines that a transaction or part of a transaction was unfair or unconscionable, it can make a number of orders including ordering that money be restored to the consumer and that the consumer be compensated for any losses. The consumer can approach a court as courts are authorised to deal with contraventions of sections 40, 41 and 48.

3.4 Enforcement of the Act

3.4.1 The National Consumer Commission

The NCC is an organ of state which has been established in terms of Chapter 5, Part B of the CPA. The jurisdiction of the NCC extends throughout the Republic. The Commission serves as the primary enforcement body for the CPA and receives and investigates complaints concerning allegedly prohibited conduct or offences. It also monitors the consumer market with a view to preventing prohibited practices from occurring and to prosecute offenders should such practices be detected. In addition, the Commission deals with the issue and enforcement of compliance notices. The CPA permits the NCC to issue a compliance notice to anyone who has contravened the CPA by engaging in conduct which the Act deems prohibited. Should the person on whom the notice is served fail to abide by it, the NCC has the option of either referring the matter for prosecution by the NPA or applying to the National Consumer Tribunal (NCT) seeking the imposition of an administrative fine.

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215 Section 52 of the CPA.
216 Section 52 (3) of the CPA.
217 Section 52 of the CPA.
219 Section 85(1)(a) of the CPA.
221 Section 99(b) of the CPA.
223 Ibid.
224 Section 100(1).
3.4.2 The National Consumer Tribunal

Chapter 2, Part B of the National Credit Act (the NCA)\(^{226}\) establishes the NCT. Like the NCC, the Tribunal has jurisdiction throughout the Republic.\(^{227}\) It has functions similar to a court and has similar status to that of a High Court.\(^{228}\) The NCT conducts hearings regarding complaints pertaining to both the NCA and the CPA and adjudicates on such matters.\(^{229}\) Section 73(2)(b) of the NCA empowers the NCT to deal with referrals from the NCC alleging prohibited conduct.

Some of the orders the NCT can make where prohibited conduct is concerned include; declaring that the conduct is prohibited, issuing an interdict and imposing administrative fines.\(^{230}\) However like CAFCOM, the NCT cannot order damages.\(^{231}\)

In terms of section 151(2) of the NCA and section 112(2) of the CPA, an administrative fine ‘may not exceed the greater of (a) 10 per cent of the respondent’s annual turnover during the preceding financial year; or (b) R1 000 000’. Failure to comply with an NCT order may result in a fine, imprisonment for not more than 10 years or both.\(^{232}\)

If the matter was heard by only one member of the NCT, the decision may be appealed before a full panel.\(^{233}\) If the matter was heard by the full panel, the participant in the hearing can, upon application to the High Court, have the decision reviewed or appeal against it.\(^{234}\)

3.5 The CPA and the Common Law

The CPA does not alter the common law in its entirety,\(^{235}\) nor does it take away any rights consumers have under the common law.\(^{236}\) The common law recognises fraud as both a crime and a delict.\(^{237}\) If a contract was fraudulently induced, the innocent

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\(^{226}\) Act 34 of 2005.

\(^{227}\) Section 26(1)(a) of the NCA.


\(^{229}\) Ibid.

\(^{230}\) Section 150 of the NCA.

\(^{231}\) Woker ‘Why the need for consumer protection legislation? A look at some of the reasons behind the promulgation of the National Credit Act and the Consumer Protection Act’ (2010) 31(2) Obiter 221.

\(^{232}\) Section 160 read with section 161 of the NCA.

\(^{233}\) Section 148(1) of the NCA.

\(^{234}\) Section 142(a) and (b) of the NCA.


\(^{236}\) Section 2(10) of the CPA.

party is entitled to institute legal proceedings against the wrongdoer in order to have the contract set aside. In addition, the innocent party can claim damages. With the enactment of the CPA, certain practices are specified as being prohibited, with the result being that an administrative fine is imposed on anyone found to be engaging in such practices.

A contravention of section 43 could also result in the guilty party being charged with fraud. Fraud may be defined as ‘unlawfully making, with intent to defraud, a misrepresentation which causes actual prejudice or which is potentially prejudicial to another’. It is argued that the perpetrators of a pyramid scheme, by promoting and participating in the scheme, unlawfully and intentionally make misrepresentations to potential recruits. These misrepresentations relate to the fact that the scheme is a ‘no-fail investment opportunity’. These misrepresentations have the effect of prejudicing or potentially prejudicing others because if they fall in the lower levels of the pyramid, they stand to lose their initial investment and it is unlikely that they will generate any profit as promised at the outset. According to section 2(10) of the CPA, ‘no provision of this Act must be interpreted so as to preclude a consumer from exercising any rights afforded in terms of the common law’. Thus, perpetrators of pyramid schemes may be charged with fraud.

3.6 Conclusion

South Africa is attune to the problem of pyramid schemes in the country. The DTI took action in 1980 and imposed conditions regulating pyramid schemes, however, these conditions proved cumbersome rather than effective. They were replaced by the Business Practices Act of 1988 and its subsequent amendment, the Consumer Affairs

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238 Ibid.
239 Ibid 55.
243 Ibid.
244 Ibid.
(Unfair Business Practices) Act. Under this Act, the BPC (renamed CAFCOM) was empowered to conduct either general or specific investigations into harmful (thereafter unfair) business practices. These investigations yielded three common practices, one of which was promotional pyramid schemes. If the Minister of Trade and Industry agreed that the scheme which was the subject of the investigation was unfair, he could declare the scheme prohibited and order that the practice be discontinued. The problem with this, however, was that a breach in the Minister's order could only be dealt with by the SAPS or NPA, bodies which were already inundated with criminal matters.

The Consumer Affairs (Unfair Business Practices) Act was the immediate predecessor of the CPA. Despite the Act being replaced by the CPA, the CAFCOM investigations influenced section 43 of the CPA. Section 43 expressly prohibits pyramid and other related schemes. In addition, section 43(6) allows the Minister to declare schemes which have an effect similar to a pyramid scheme as prohibited. Both the promotion of and participation in these schemes is deemed unlawful. Moreover, the CPA also prohibits false, misleading and deceptive representations as well as unconscionable conduct thus providing the consumer with alternative avenues should they discover that they have become involved in a scheme which contravenes the CPA, whether it be a pyramid scheme, or they have been misled about the true nature of the business opportunity they have invested in.

The NCC is tasked with investigating complaints and may issue a compliance notice where prohibited conduct is concerned. Thus, for example, the NCC may issue a notice informing the business that it must cease promoting its scheme, refund consumers their investments or stop using certain advertising or marketing strategies as these are, for example, misleading. Failure to comply with a compliance notice may result in either prosecution by the NPA or further investigation by the NCT.

The NCT is empowered to impose administrative penalties of up to R1 million or 10% of a business's annual turnover. Therefore, even if a business does not go as far as becoming a pyramid scheme, there may be other aspects of the business, such as the manner in which it is being promoted, which contravenes the CPA.

Aggrieved consumers can also approach the normal civil courts and ask for a remedy in terms of section 52 (3) of the CPA which may mean they are able to claim a refund
of their investment and any other costs which they have incurred. Perpetrators of pyramid schemes may also be charged with the criminal offence of fraud under the common law.
Chapter 4
Herbalife and the American experience

4.1 Introduction
As mentioned previously, Herbalife is an international direct selling company involved in the production, promotion and sales of nutritional products. These include sport supplements and products which assist with weight management. The name Herbalife has become synonymous with the term pyramid scheme with many allegations being directed at the company and, in particular, its compensation structure. To determine whether these allegations have any merit, Herbalife’s business model will be considered, as will the facts, findings and outcome of the FTC investigation undertaken in the United States of America. This will be followed by an overview of the current legal debates surrounding Herbalife in the United States.

4.2 Criticisms of Herbalife
Many have criticised Herbalife claiming that its business operations are closer to a pyramid scheme rather than an MLM company. In the United States, one such accusation was made by television show host, John Oliver, who, on his show Last Week Tonight, publicly exposed Herbalife claiming that its so-called business opportunity was in fact a scam. Another notable allegation was made in December 2012 by Bill Ackman, a hedge fund manager who founded Pershing Square Capital Management. Ackman’s claim that Herbalife was a pyramid scheme triggered the FTC investigation. Among the reasons advanced by Ackman in support of his

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245 Herbalife International of America, Inc and Herbalife International, Inc. are subsidiaries of Herbalife Nutrition Ltd (formally Herbalife Ltd). They will collectively be referred to as Herbalife or the company. Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 3.
246 Multilevel Marketing: Last Week Tonight with John Oliver (HBO) available at https://www.youtube.com/watch?v=s6MwGeOm8il accessed on 21 February 2018.
accusation was that Herbalife misrepresented to new members the income they could make by pursuing the Herbalife opportunity.\textsuperscript{249} In addition, the company did not disclose that it was highly unlikely that members would make a substantial income and that the majority of rewards advertised by the company were earned by Herbalife’s top 1\% of distributors.\textsuperscript{250} Ackman also asserted that the company incentivised recruitment and made use of recruiting materials that were materially deceptive.\textsuperscript{251} He also accused the company’s nutrition clubs, which serve as a means of recruiting more members, of having the characteristics of pyramid schemes.\textsuperscript{252} One of Ackman’s key criticisms related to Herbalife’s compensation structure. He claimed that the distributors were compensated in a manner more akin to pyramid schemes than MLM programmes.\textsuperscript{253}

4.3 Herbalife’s response

In a press release dated 20\textsuperscript{th} December 2012, Herbalife responded to Ackman’s allegations and expressly stated that, ‘Herbalife is not an illegal pyramid scheme’.\textsuperscript{254} The company asserted that its business practices and products were constantly reviewed and external experts ensured that Herbalife operated in accordance with the law.\textsuperscript{255} Herbalife also disclosed the findings from an economic analysis of its business practices. According to the findings in this analysis, Herbalife conducted its business like an MLM model and not in a pyramidal-like manner.\textsuperscript{256} The analysis also revealed

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{250} Ibid.
\item \textsuperscript{251} Ibid.
\item \textsuperscript{252} Majola and Dini ‘All that glitters: an exploration of the Pyramid Scheme and Ponzi Scheme phenomena and what the law is doing to protect consumers’ 15 July 2015 available at https://www.lexology.com/library/detail.aspx?g=c62b13a4-d053-48d5-bef2-3b1ac7a85351 (accessed on 21 February 2018).
\item \textsuperscript{255} Ibid.
\end{enumerate}
\end{footnotesize}
that Herbalife provides members with a ‘reasonable prospect of operating a financially successful business’.\textsuperscript{257} Michael Johnson, who was the CEO of Herbalife at the time, denied Ackman’s allegations and was reported to have said that the company does not pay for recruiting.\textsuperscript{258}

\textbf{4.4 Herbalife’s Sales and Marketing Plan}

In order to assess whether the criticisms levelled against Herbalife (i.e. that it operates as a pyramid scheme) have any merit, it is necessary to understand its Sales and Marketing Plan. Herbalife operates a multi-level Sales and Marketing Plan with the lowest level occupied by distributors or members and the highest level being President’s Team.\textsuperscript{259} There are different benefits associated with every level that help determine how members are compensated.\textsuperscript{260}

There are two main ways in which members can generate an income. Firstly, members can derive profits from their resale of Herbalife products, after having subtracted their expenses.\textsuperscript{261} This is known as profit on own sales.\textsuperscript{262} Secondly, members may choose

\begin{itemize}
\item \textsuperscript{257} Ahuja and Kelly ‘Herbalife Disputes Ackman’s Claim of ‘Pyramid Scheme’ 19 December 2012 available at https://www.cnbc.com/id/100328657 (accessed on 17 October 2018).
\item \textsuperscript{258} As of 2013, distributors became known as members. However, this did not result in any substantive change to Herbalife’s business opportunity. The words distributor and member will thus be used interchangeably. \textit{Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 4.}
\item \textsuperscript{260} Expenses include but are not limited to ‘advertising or promotional expenses, product samples, training, rent, travel, telephone and Internet costs, and miscellaneous expenses’. Herbalife ‘Sales and Marketing Plan’ May 2014 page 20 available at http://assets.factsaboutherbalife.com/content/uploads/2015/10/26133816/SalesAndMarketingPlan.pdf (accessed on 9 July 2018).
\item \textsuperscript{261} Ibid.
\end{itemize}
to sponsor others, thereby enabling those that they sponsor to become members. In this way the sponsors form individual downline sales organisations. Members are not financially compensated simply for introducing or sponsoring new members, instead, they are compensated for products sold to their downline either for personal consumption or for resale. This is termed multilevel compensation.

Every Herbalife product is allocated a Volume Point value. Members earn credit for products ordered (volume) and this is calculated using the Volume Points of the products concerned. The points accumulated are used to calculate the qualifications and benefits a member is eligible to receive.

When members purchase products, they receive a discount, known as a wholesale discount, which ranges from 25% to 50% off earn base. These products are then sold to customers. The difference between the selling price (what the customer pays) and the cost price (what the member paid) is known as the member's retail profit. Members can also earn commission (also known as wholesale profit) on products purchased by their downline. The difference in the cost which members pay and the discounted amount which is paid by their downline equates to wholesale profit.

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265 Ibid.
266 Ibid 11.
268 Earn base value is defined as ‘the value assigned to a product, in local currency, on which discounts and earnings are calculated’. Ibid 24.
270 Ibid 11.
271 Ibid.
272 Ibid.
If a member’s total volume increases, they may become a senior consultant. As a
senior consultant they are entitled to a discount of 35% to 42% off earn base when
purchasing products and stand to make a greater profit.

In addition to retail and wholesale profit, those who reach the level of Herbalife
supervisor can also earn royalty overrides of 1% to 5%. Royalty overrides are
calculated on a supervisor’s monthly total volume. However, if a supervisor earns less
than 500 volume points, they do not qualify for royalty overrides. If a supervisor earns
2500 volume points or more, they receive the maximum 5% on three of their active
downline levels. In addition to meeting the aforementioned requirements, supervisors
must adhere to the 10 Retail Customers Rule and the 70% Rule in order to qualify
for royalty overrides.

A supervisor may also be eligible for royalty override roll-ups. This occurs when a
supervisor who earns a 5% royalty override has downline royalty contributing
supervisors who do not earn the maximum 5% royalty override. The override roll-up
earned by the supervisor is equivalent to 5% minus the percentage override actually
earned by the contributing supervisor.

If a supervisor goes on to achieve Top Achievers Business (TAB) Team status, they
qualify for a production bonus which is based on the volume of their entire
organisation, with the minimum bonus being 2% and the maximum 7%. This is paid
to the TAB team on a monthly basis. To qualify for a production bonus, the team must
also abide by the 10 Retail Customers Rule and the 70% Rule. A TAB team can

273 Total Volume is equivalent to Personal Volume plus Group Volume. Personal Volume is ‘the volume from orders purchased by you as a Fully Qualified Supervisor and all others in your downline organization, excluding any 50% orders by Qualifying or Qualified Supervisors’. Group Volume is defined as ‘orders purchased at a temporary 50% discount, by Qualifying Supervisor(s) in a Supervisor’s personal organization’. Ibid 25.
274 Ibid 12.
275 Ibid 17.
276 According to this rule ‘a Member must make sales to at least 10 separate retail customers each month to qualify and receive Royalty Overrides and Production Bonus’. Ibid 25.
277 According to this rule ‘in any given month, a Member must sell to retail customers, and/or sell at wholesale to downline Members, at least 70% of the total value of Herbalife products they hold for resale, in order to qualify for TAB Team and to earn and receive Royalty Overrides and Production Bonus for that month’s business’. Ibid.
278 Ibid 17.
279 Ibid.
280 Ibid 19.
281 Ibid.
also earn a production bonus on another TAB team in their downline if that team has a lower production bonus percentage. This production bonus will be the difference between the TAB team’s production bonus percentage and the downline TAB team’s production bonus percentage.\textsuperscript{282} The production bonus is regarded as a reward for a TAB team’s leadership and loyalty.\textsuperscript{283}

Some of Herbalife President’s Team members may receive an additional bonus known as the Mark Hughes Bonus. This is an annual bonus awarded to members who displayed superior leadership and motivation during the preceding year,\textsuperscript{284} and is also an acknowledgement of their role in the sale of Herbalife products.\textsuperscript{285} This bonus can be a maximum of 1% of the company’s worldwide sales.\textsuperscript{286}

Herbalife members may also receive recognition awards such as pins, plaques and jewellery, upon reaching a certain level or obtaining a certain qualification.\textsuperscript{287} Members may sometimes also qualify for Herbalife vacations and training events.\textsuperscript{288}

\textsuperscript{282} If both TAB teams attain the same production bonus percentage, the upline team can earn on the downline team but not on that team’s downline. If a downline team earns a higher production bonus than an upline team, the upline team cannot earn a production bonus on the downline team or their downline. Herbalife ‘Sales and Marketing Plan’ May 2014 page 25 available at http://assets.factsaboutherbalife.com/content/uploads/2015/10/26133816/SalesAndMarketingPlan.pdf (accessed on 9 July 2018).


\textsuperscript{288} Ibid 19.
4.4.1 Key criticisms of this Sales and Marketing Plan

Those who criticise this Sales and Marketing Plan have identified the following key problem areas:

- members need to purchase high quantities of products;
- the products are very costly;\(^{289}\)
- there is an underlying element of deception to the scheme;\(^{290}\)
- revenues are not distinguished from profits;
- the costs associated with being a distributor are not revealed;\(^{291}\)
- Herbalife has a very complex commission structure;\(^{292}\)
- sponsors do not properly explain how members will progress in the compensation hierarchy and there are many difficulties associated with trying to progress;\(^{293}\)
- difficulties associated with certain forms of compensation in particular are not explained;\(^{294}\)
- the company places a great deal of emphasis on recruitment; and
- only a small minority seem to benefit financially.\(^{295}\)

To elaborate, critics argue that in order to be eligible for and benefit from Herbalife bonuses, distributors and their recruits need to purchase many products.\(^{296}\) These products are overpriced and exploit poor consumers who are deceived into purchasing products they are incapable of selling or do not wish to consume.\(^{297}\) Despite the cost of these products and the fact that there is a good chance they will not be sold or used

\(^{290}\) Ibid.
\(^{291}\) Ibid.
\(^{292}\) Ibid.
\(^{293}\) Ibid.
\(^{294}\) Ibid.
\(^{295}\) Arguments as to why Herbalife’s compensation plan resembles a pyramid scheme can be found on the Facts About Herbalife website available at https://www.factsaboutherbalife.com/the-facts/the-herbalife-compensation-plan/ (accessed on 8 November 2018).
\(^{296}\) Ibid.
\(^{297}\) Ibid.
by the members, members buy products because the purchase is coupled with a perceived business opportunity. Consumers labour under the false impression that by simply participating in the scheme they will be able to derive a substantial income.

This impression is created in part by Herbalife’s complex commission structure. The perception is that because there are multiple ways to earn income with Herbalife, it is easy to do so. Critics disagree with this perception claiming that it is difficult to earn money from these various streams and to do so requires massive downlines. Moreover, sponsors do not inform recruits of this difficulty. Recruits are merely told that in order to advance in the compensation hierarchy they need to put in hard work and effort. Production bonuses in particular pose a problem because they are payable on infinite levels. In other words, a distributor will receive a production bonus on each level of their downline regardless of how many levels there are. This is problematic because it is a further indication that Herbalife incentivises recruitment.

The promotional vacations offered by Herbalife are also criticised. These promotions usually have high qualification thresholds and result in upline distributors pressurising their downlines to purchase many products, to meet the threshold, even though there is no consumer demand for the products. Herbalife products may also be difficult to sell because similar products can be found at retail stores where they are not as expensive. Furthermore, Herbalife does not divulge the number of other distributors who are selling products in a particular area. This failure to disclose can result in distributors competing for the same consumer market. A further problem exists when there are higher-level distributors working in the same market as entry-level distributors. Higher-earning distributors qualify for greater discounts on products, so

299 Ibid.
300 Criticisms about Herbalife’s compensation plan can be found on the Facts About Herbalife website available at https://www.factsaboutherbalife.com/the-facts/the-herbalife-compensation-plan/ (accessed on 8 November 2018).
301 Ibid.
302 Ibid.
303 Ibid.
304 Ibid.
305 Ibid.
306 Ibid.
307 Ibid.
it is possible for them to sell those products at a lower cost than entry-level distributors. This makes it even more difficult for newer distributors to find consumers.

The Herbalife compensation and commission structure is criticised as a whole for operating in a way that only allows those at the top of the compensation plan to prosper financially. These top-level distributors will prosper at the expense of those at the bottom of the commission structure.\(^{308}\) It is argued that only a few distributors who join Herbalife will make money and their profits are derived from recruiting new members, convincing them to purchase products and encouraging them to recruit others. This is possibly the main criticism of the Herbalife Sales and Marketing Plan because it resonates with the principal feature of a pyramid scheme namely, income is derived primarily through the introduction of new recruits as opposed to the sale of goods or services to consumers. Upline distributors advance in the company hierarchy, obtain greater discounts and they receive commission when distributors below them purchase Herbalife products from the company, hence, distributors are incentivised to recruit and are essentially paid to recruit.\(^{309}\)

### 4.5 Arguments in favour of Herbalife as a legitimate MLM programme

The view that Herbalife is a pyramid scheme is not supported by all. Those who oppose this view highlight certain characteristics of Herbalife’s Sales and Marketing Plan and its business model which, it is argued, demonstrate that it is a legitimate MLM programme.

Coughlan, a professor of marketing, argues that Herbalife distributors are compensated based on their role in generating product sales and not for mere recruitment.\(^{310}\) She argues further that the registration fee payable by members upon joining the organisation is low. Upon registration, members are required to purchase

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\(^{308}\) Ibid.

\(^{309}\) Arguments as to why Herbalife’s compensation plan resembles a pyramid scheme can be found on the Facts About Herbalife website available at https://www.factsaboutherbalife.com/the-facts/the-herbalife-pyramid-scheme/ (accessed on 8 November 2018).

either a Mini International Business Pack (IBP) or a full IBP. The mini IBP includes, amongst other things, samples of Herbalife products while the full IBP contains some full-sized products. At that time, in the United States, the price of the mini IBP was $57.75 and the full IBP was $95.55. According to Coughlan this was lower than the median cost of starter kits which the United States Direct Selling Association reported to be $99. It should be noted, however, that the cost of these packs has since escalated. As of November 2017, the IBP cost approximately $94.10 and the IBP Super Starter cost $124.10. Both figures exclude tax and shipping.

Coughlan also asserts that, unlike goods sold by pyramid schemes, Herbalife’s products are valuable to consumers. Herbalife is committed to ensuring that they produce quality products and it spends a considerable amount of money on scientific research and employs highly qualified staff to do this research. It is suggested by Coughlan that Herbalife’s long-standing history is evidence that its products are valuable to consumers. Herbalife, in its Sales and Marketing Plan also provides a return policy. If customers are not satisfied with the products they have purchased, they can, subject to the fulfilment of certain conditions, appeal to the member from whom they purchased the products, for a refund. According to Herbalife, this refund policy exists because the company firmly believes in its products and assures the quality thereof. Coughlan also points out that products are widely sold to consumers

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311 As of 2013, the IBP also became known as the Herbalife Member Pack. Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief 15 July 2016 page 29.


314 Information regarding the cost of Herbalife member packs is available at https://www.myherbal.co/hmp-herbalife-member-pack-price/ (accessed on 10 October 2018).


317 Information pertaining to Herbalife’s return policy can be found on the Herbalife South Africa website available at http://www.herbalife.co.za/terms-of-use (accessed on 11 November 2018).
external to the organisation and not only to other distributors. However, according to Coughlan, this latter point is only relevant in assessing whether a scheme is a pyramid scheme if the products in question have little or no value and sales are driven solely by recruitment.\textsuperscript{318} Her main argument, as stated above, is that the Herbalife products have value for consumers.

Herbalife distributors are also discouraged from engaging in inventory loading.\textsuperscript{319} Distributors are told that products must be purchased in order to be sold to retail customers or distributed through a distributor’s downline or should be consumed personally by the distributor and/or their families.

The company also offers a buyback policy which allows members wanting to resign to return, in exchange for a full refund, unopened products which they have purchased within the past year and which remain in their possession.\textsuperscript{320} Herbalife will also pay for shipping and, if resignation occurs within a member’s first year at Herbalife, they will also be refunded in full for the starter pack purchased.\textsuperscript{321} Furthermore, within 90 days of joining Herbalife, a distributor is entitled to forgo the business opportunity and their sponsor is obliged to accept this together with the return of any unsold inventory.\textsuperscript{322}

### 4.6 The United States of America investigation

Before considering the actual investigation into Herbalife by the American authorities, it is necessary to have a brief understanding of the applicable law in the United States.\textsuperscript{323}


\textsuperscript{319} Ibid.


\textsuperscript{321} Ibid.


\textsuperscript{323} It is not possible in a mini-dissertation to discuss the law in detail and so only those areas of the law which are relevant are set out in summary below.
4.6.1 The FTC and the FTC Act

The FTC is the American equivalent of the NCC and the NCT.\textsuperscript{324} It is an independent government agency whose responsibility includes, \textit{inter alia}, to ensure consumer protection under the Federal Trade Commission Act of 1914 (the FTC Act).\textsuperscript{325} The FTC Act is similar to the CPA in that it outlaws certain conduct. Under section 5 of the FTC Act, unfair or deceptive acts and practices are prohibited as well as unfair methods of competition. Section 5 also mandates the disclosure of material terms to a contract. False, misleading and unsubstantiated material representations concerning the income a potential member is likely to earn are an infringement of section 5.\textsuperscript{326} A company must be able to substantiate its claims with objective evidence.\textsuperscript{327} Claims which are true may not necessarily be a reflection of typical results for example, get-rich-quick advertisements, lifestyle testimonials and hypothetical earnings. If such claims cannot be attained by the majority of members, they may be deemed misleading.\textsuperscript{328}

The FTC Act empowers the FTC to conduct formal investigations into companies, obtain injunctive relief to prevent further consumer injury and bring administrative enforcement actions with the aim of obtaining financial redress for consumers.\textsuperscript{329} Enforcement actions generally result in the conclusion of consent orders,\textsuperscript{330} which is the South African equivalent of settlement agreements.

\begin{footnotes}
\textsuperscript{324} Information regarding the respective consumer protection agencies worldwide can be found on the FTC website available at https://www.ftc.gov/policy/international/competition-consumer-protection-authorities-worldwide (accessed on 17 November 2018).
\textsuperscript{326} Ibid.
\textsuperscript{327} Ibid.
\textsuperscript{328} Ibid.
\textsuperscript{329} Ibid.
\textsuperscript{330} Ibid.
\end{footnotes}
4.6.2 The FTC investigation into Herbalife

Prompted by the allegations that Herbalife was acting improperly, the FTC launched an investigation into its business model.331 The FTC’s argument primarily centred around Herbalife’s income misrepresentations. The company claimed that those who joined the scheme could make a substantial income, either part time or full time.332 This message was communicated through various mediums of advertising such as videos, live presentations, as well as print materials.333

The FTC argued that a consideration of its compensation plan revealed that rather than incentivising retail sales, Herbalife incentivised the recruiting of further members who make wholesale purchases of products.334 The FTC pointed out that retail sales were not very lucrative and were possibly only sufficient to lessen the costs of participating in the programme. It was also established that just a few distributors made money from the Herbalife programme and that instead of making money, many members actually lost money.335

Although Herbalife sometimes displayed disclaimers in conjunction with the representations it made regarding potential earnings, it was argued that this did not detract from the overall impression that the message sent out by Herbalife created, namely, that distributors could generate a considerable income.336 It was further argued that these disclaimers were usually in fine print and often contained reference to another document such as Herbalife’s Statement of Average Gross Compensation. In order to fully understand the message, distributors would have to access and read further documents. Even if distributors did go to the lengths of reading these documents, it was found that these documents did not convey realistic expectations either.337

333 Ibid 5.
335 Ibid 5.
336 Ibid.
337 Ibid 5-6.
Moreover, Herbalife videos, which were accessible on Herbalife websites and included in the mandatory starter pack that distributors purchased, contained images of lavish cars, houses and holiday destinations. These videos also included income testimonials. As a whole, the FTC argued, the message that these videos portrayed was that becoming a Herbalife distributor was an opportunity for earning a substantial income.

It was also suggested that at live presentations, Herbalife usually chose, as presenters, those who were among the few who had reached the higher ranks in the company. These presenters repetitively stated that the Herbalife opportunity was one which was accompanied by substantial income, subject only to the effort that was put in by distributors. The FTC also noted that these presentations usually involved distributors buying a minimum number of Herbalife products to attend and/or paying a fee to attend.

Herbalife also included print publications, such as a document entitled ‘Your Business Basics’, which led customers to believe that they could earn additional income on a monthly basis, with no bar to their financial potential, and be successful like thousands of others who had joined Herbalife. Another form of print publication was the Presentation Book which, from the period of 2012 to 2014, had been included as part of the Herbalife starter pack. This book was created with the intention of being shown to possible recruits. Contained in the book was the statement that Herbalife provided ‘[t]he opportunity to earn more than you ever thought possible and make your dreams come true!’ Accompanying this statement were pictures of fancy cars, houses, boats and dollar bills.

Distributor testimonials were also contained in the Presentation Book as well as in Herbalife Today, an online Herbalife magazine. In these testimonials, distributors spoke about how Herbalife had had a life-changing impact on them and how, ever since becoming a member, they had financially prospered.

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339 Ibid 6-8.
341 Ibid.
342 Ibid 11-12.
344 Ibid.
Herbalife promotional material, such as videos and print material mentioned above, also portrayed to consumers the idea that significant income could be earned through retail sales of Herbalife products.\textsuperscript{345} It was argued by the FTC that such representations were misleading. This was because Herbalife did not record ‘either the existence or profitability of Distributor attempts to retail Herbalife products’.\textsuperscript{346} This statement can be supported by one made by Des Walsh, former President of Herbalife. When asked how many products were sold to non-Herbalife members, Walsh replied ‘we don’t track this number and do not believe it is relevant’.\textsuperscript{347} The company did, however, conduct a survey in 2014, the results of which revealed that only 39\% of product sales were to those outside of the organisation.\textsuperscript{348} According to the FTC, ‘the overwhelming majority of Herbalife Distributors who pursue the business opportunity make little or no money from retail sales’.\textsuperscript{349}

The FTC alleged that Herbalife created the impression that its members could obtain a substantial financial benefit from retail sales.\textsuperscript{350} The FTC claimed that this was partially achieved through the promotion of nutrition clubs.\textsuperscript{351} Herbalife members lease premises or make use of their homes to operate nutrition clubs. Customers are required to pay a membership fee to join the club, following which they may consume certain Herbalife products on site. Customers are not charged individually for the products they consume. A key feature of these clubs, as noted by the FTC, is that products cannot be purchased on site. According to the FTC, the impression created by Herbalife that nutrition clubs generate substantial income for their respective owners is incorrect.\textsuperscript{352} Instead, club owners most often ran a loss because the associated costs of running the club were greater than the cumulative membership fees collected.\textsuperscript{353} The FTC claimed that these clubs served instead as a means of

\begin{flushright}
\textsuperscript{345} Ibid 14.  \\
\textsuperscript{346} Ibid 18.  \\
\textsuperscript{349} Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 18.  \\
\textsuperscript{350} Ibid 19.  \\
\textsuperscript{351} Ibid.  \\
\textsuperscript{352} Ibid 20.  \\
\textsuperscript{353} Associated costs include purchasing the products and renting the premises. Ibid 20-21.
\end{flushright}
recruiting new members.\textsuperscript{354} If customers became members and then nutrition club owners themselves, the club owner who recruited them could become successful if the new owner purchases products for their club from the original owner.

In relation to the purchasing of products, the FTC stated that distributors were pressured to buy in bulk in order to benefit from greater wholesale discounts.\textsuperscript{355} Furthermore, Herbalife’s buyback policy is subject to the distributor resigning.\textsuperscript{356} Thus, a distributor cannot return their unsold products and retain their status as a distributor.

Despite Herbalife’s statements that income is retail-based, it was established that income was actually dependent on recruitment.\textsuperscript{357} Sponsors earned money by purchases made by their downline. The importance of recruitment was emphasised by Herbalife in its printed publications. Material such as the \textit{Presentation Book} illustrated how a distributor could earn money through recruiting others who in turn brought in new recruits. This is termed the ‘power of duplication’.\textsuperscript{358} The role of recruitment in Herbalife’s compensation plan was also highlighted by one of the members of Herbalife’s Founder’s Circle during a live presentation in 2009. At the presentation it was stated that royalty was ‘the name of the game’ and could only be earned through helping other distributors become successful and not through consumers.\textsuperscript{359} In a Spanish presentation a Herbalife President’s team member is reported to have said that ‘the only way to scale the ladder of success is through sponsorship’.\textsuperscript{360}

The FTC established that recruitment was the only way in which a distributor could possibly earn a substantial income.\textsuperscript{361} Herbalife compensated its distributors based on the volume of products purchased by their downline and not actual retail sales. Thus, there was an incentive for recruiting new members and to encourage these recruits to purchase a high quantity of products.\textsuperscript{362}

\textsuperscript{354} Ibid 21.
\textsuperscript{355} Ibid 22.
\textsuperscript{356} Ibid.
\textsuperscript{357} Ibid 23-24.
\textsuperscript{358} Ibid 25.
\textsuperscript{359} Ibid.
\textsuperscript{360} Ibid.
\textsuperscript{361} Ibid 26.
\textsuperscript{362} Ibid 29.
The FTC criticised Herbalife’s compensation plan commenting that members transcended to higher levels in the organisation and were entitled to rewards based on product purchases as opposed to product sales and these higher levels could only be reached by recruitment.363 A member’s progress was dependent on substantial wholesale product purchases made either personally or by their downline. The Herbalife compensation plan created an incentive for distributors to recruit others because distributors could earn different types of profit from creating a downline.364 In essence, the greater the distributor’s downline, the higher they would progress, the greater rewards they would reap. There ought to be a reasonable likelihood that members could derive a profit from the resale of products. However, the FTC found that the majority of Herbalife members made little or no profit from the sale of Herbalife products and some even lost money.365

4.6.3 The outcome of the FTC investigation and its impact on Herbalife

The FTC concluded that Herbalife’s practices were unfair because the company incentivised members to purchase products and to enlist others to also purchase products. Advancing in the Herbalife business opportunity was dependent on product purchases and not actual retail demand.366 The FTC concluded that these actions of Herbalife ‘cause or are likely to cause substantial injury to consumers that consumers cannot reasonably avoid themselves’.367

In addition, Herbalife was found guilty of income misrepresentation as well as ‘false or unsubstantiated claims of income from retail sales’, particularly in its marketing and advertising practices.368 These conclusions were reached because the company conveyed the impression that, by joining Herbalife, members were likely to earn a substantial income, however this was often not the case and was seldom

363 Ibid 30.
364 Ibid 32.
365 Ibid 38.
366 Ibid 39.
367 Ibid.
accompanied by supporting evidence. These misrepresentations contravened the FTC Act because they were deceptive.\textsuperscript{369}

The FTC investigation culminated in a settlement agreement with Herbalife.\textsuperscript{370} Though the FTC did not conclude that Herbalife was a pyramid scheme \textit{per se}, it did require the company to make certain changes.\textsuperscript{371} In the settlement agreement, Herbalife consented to restructuring its business so that compensation is determined by actual retail sales as opposed to wholesale purchases made by distributors and their downlines. According to the agreement, a minimum of 80\% of Herbalife sales needs to be to legitimate end-users, failing which, rewards must be reduced to lower levels. Actual retail sales will be evidenced by receipts and Herbalife will also monitor sales and distribution via a mobile application.\textsuperscript{372}

The order also required that an Independent Compliance Auditor observe, for seven years, how Herbalife restructures its compensation plan and ascertain whether Herbalife acts in accordance with the structural provisions.\textsuperscript{373}

In addition, Herbalife was required to pay $2 million as a form of consumer redress. Cheques were awarded to approximately 350,000 people with the intention of compensating them for financial loss suffered as a result of Herbalife’s misleading income representations.\textsuperscript{374} The company was also precluded from misleading consumers further.

\textsuperscript{369} Ibid 40.
\textsuperscript{372} Ibid.
\textsuperscript{373} Ibid.
\textsuperscript{374} Practical Law Commercial Transactions ‘FTC Mails Redress Checks to Nearly 350,000 Victims of Multi-Level Marketing Scheme’ (2018) Practical Law Legal Update w-005-3480 available on Thomson Reuters Westlaw (accessed 7 April 2018).
4.7 Current allegations against Herbalife

Presently, in the United States, there is a federal lawsuit against Herbalife. The distributors who instituted legal action claim that Herbalife coerced them into attending numerous events entitled ‘Circle of Success’ which were costly but which were not ‘the secret to wealth’ as they purported to be. Herbalife seeks to have the matter dismissed or, alternatively, transferred to a court in California. According to Herbalife, the distributors did not properly articulate how they were deceived. Herbalife also contends that many of the claims in the present case were addressed in the FTC settlement agreement. The plaintiffs disagree claiming that these events were not covered under the FTC investigation. The outcome of these newfound allegations has yet to unfold.

4.8 Conclusion

Herbalife’s business model and operations appear to be a contentious issue. Whilst some are convinced that the company operates a pyramid scheme because of its emphasis on recruitment, others argue that the Herbalife business opportunity

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375 Fin 24 ‘Herbalife distributors claim in $1 billion lawsuit that 'success' events were a sham’ 21 August 2018 available at https://www.fin24.com/Economy/herbalife-distributors-claim-in-1-billion-lawsuit-that-success-events-were-a-sham-20180821 (accessed on 11 October 2018).
377 On August 23rd 2018, it was ordered that the matter be divided into two parts with claims against independent distributors being heard in Miami whilst action against the company as a whole proceeds in California. However, the order was subsequently appealed with proceedings stayed in the interim. Information regarding this can be found on the Behind MLM website available at https://behindmlm.com/companies/herbalife/some-herbalife-distributors-get-arbitration-venue-change-to-california/ (accessed on 21 January 2019).
381 See for example Multilevel Marketing: Last Week Tonight with John Oliver (HBO) available at https://www.youtube.com/watch?v=s6MwGeOm8iI accessed on 21 February 2018 and Thomson Reuters ‘Ackman calls Herbalife a ‘pyramid scheme’ 20 December 2012 available at
bears semblance to that of a legitimate MLM firm. Those who favour the latter view cite Herbalife’s buyback policy, discouragement of inventory loading, minimal start-up costs and offering of legitimate products with real value, in support of their argument.

Herbalife denied the complaints and allegations made against it. These allegations were subsequently addressed by the FTC in its investigation. The FTC ultimately held that Herbalife was not a pyramid scheme, however, the outcome was not all that favourable for Herbalife. The FTC found that the company was guilty of misleading its members by misrepresenting to them the income they could potentially earn. In addition, recruitment was essential to a Herbalife distributor’s progress in the company. This led the FTC to conclude that Herbalife was not a viable retail-based opportunity and that Herbalife’s actions and conduct amounted to a contravention of section 5 of the FTC Act. Consequently, Herbalife entered into a settlement agreement with the FTC in terms of which it consented to making changes to its compensation structure, to discontinue misleading consumers and to pay $2 million to Herbalife members who had been misled and suffered financial loss as a result thereof. To ensure compliance with the settlement agreement, the FTC also ordered that, for seven years, an Independent Compliance Auditor must monitor how Herbalife restructures its compensation plan. As of late, there have been further allegations against Herbalife with distributors alleging misrepresentation on the part of


384 Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016. 385 Ibid.

However, insofar as the new allegations are concerned, it remains to be seen what transpires.

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Chapter 5
Herbalife under South African law

5.1 Introduction
Herbalife began in South Africa in 1995 where it continues to operate.388 This Chapter will analyse Herbalife’s Sales and Marketing Plan in light of the relevant CPA provisions as set out in Chapter 3. Thereafter Herbalife will be viewed under the common law concept of fraud.

5.2 Herbalife in South Africa
According to the South African Herbalife Statement of Average Gross Compensation for 2017,389 South African Herbalife distributors can generate an income in two ways namely; they can profit from their own sales and multilevel compensation.390 Apart from this, the South African website does not provide detailed information regarding how members are compensated. However, the Statement of Average Gross Compensation incorporates, by reference, the United States Herbalife Sales and Marketing Plan. For this reason, the compensation and commission structure as detailed in Chapter 4 will be examined in the light of South African law.

5.3 Herbalife and section 43 of the CPA
According to the definition of pyramid scheme provided by section 43(4), a business plan will constitute a pyramid scheme when participants earn money primarily from recruitment rather than actual retail sales or, alternatively, during the promotion of the

390 The concepts profit on own sales and multilevel compensation have already been explained in Chapter 4.
scheme, recruitment is emphasised as being essential to compensation. As acknowledged by the FTC, Herbalife’s Sales and Marketing Plan incentivised recruitment because it rewarded upline distributors for wholesale product purchases made by their downline.\textsuperscript{391} Progress in the compensation hierarchy depended on recruitment and not retail sales.\textsuperscript{392} Herbalife continues to reward its members for wholesale purchases made by their downline. In 2017, 1 045 non-sales leaders in South Africa earned wholesale profit for downline purchases from Herbalife itself together with 5 016 sales leaders with a downline.\textsuperscript{393} However, following the FTC investigation, there has been an increase in product sales to legitimate end users.

In February 2017, Herbalife stated that approximately 60% of its sales were to legitimate end users and during April 2017,\textsuperscript{394} this figure increased to more than 70%.\textsuperscript{395} The company has since reached the threshold requirement of 80% of sales to legitimate end users as set out in its consent agreement concluded with the FTC.\textsuperscript{396} Despite this, if Herbalife members earn more money via recruitment than via these external sales, Herbalife will fit the South African definition of a pyramid scheme.

The definition of a pyramid scheme set out in section 43(4) contains two parts. Thus, even if recruitment is not the primary means through which Herbalife distributors earn money, Herbalife may still amount to a pyramid scheme if it is promoted in a manner that emphasises that recruitment is essential to compensation. This is because of section 43(4)(b) which makes it unlawful for an arrangement, agreement, practice or scheme to be promoted in this way.

\textsuperscript{391} Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 4.
\textsuperscript{392} Ibid 30.
\textsuperscript{393} Herbalife ‘Statement of Average Gross Compensation Paid by Herbalife Nutrition to South Africa Members in 2017’ 26 February 2018 available at https://edge.myherbalife.com/vmba/media/1A246934-C8ED-4C07-9E56-3DB0AA8F8561/Web/General/Original/SAGC_South%20Africa.pdf (accessed on 21 November 2018).
\textsuperscript{394} This information was revealed at Herbalife’s fourth-quarter and full-year 2016 earnings conference, the transcript of which is available at https://ir.herbalife.com/static-files/59bc9e2f-2795-481c-b575-564163e39191 (accessed on 21 November 2018).
\textsuperscript{395} This information was revealed at Herbalife’s First Quarter 2017 Earnings Conference Call, the transcript of which is available at https://ir.herbalife.com/static-files/3cd33d81-9dde-4ad0-bc6b-745563628e4f (accessed on 21 November 2018).
As noted by the FTC, Herbalife live presentations, as well as promotional material that existed in print and video form, stressed the importance of recruitment, discussed the ‘power of duplication’, and in one instance went as far as saying that, ‘the only way to scale the ladder of success is through sponsorship’.397 This form of advertising will fall under the latter part of the section 43(4) definition of a pyramid scheme. Engaging in the promotion of such scheme, as well as participating therein, amounts to prohibited conduct under section 43(2)(b) of the CPA. The Herbalife South Africa website does, however, contain a disclaimer warning against the scheme being promoted in a manner that emphasises recruitment and it also acknowledges the illegality thereof.398

Furthermore, in the event that Herbalife is not a pyramid scheme by definition, it may still be classified as a prohibited scheme. The Minister of Trade and Industry may, by virtue of sections 43(2)(d) and 43(6), declare Herbalife as being a prohibited scheme if he is of the opinion that its nature or effect is similar to that of a pyramid scheme. However, even if Herbalife restructures its compensation plan so that it does not resemble a pyramid scheme, or such that its nature and effect is not similar to that of a pyramid scheme, it may still fall foul of other sections of the CPA.

5.4 Herbalife and section 40 of the CPA

An interpretation of section 40 of the CPA leads to the conclusion that neither Herbalife nor any of its distributors must knowingly or unknowingly act unethically or improperly when dealing with a consumer. It is prohibited conduct for them to engage in any conduct listed in section 40. Of particular relevance is coercion, duress and pressure.

As discussed in Chapter 4, one of the criticisms of Herbalife’s Sales and Marketing Plan is the promotional vacations which the company offers. To qualify for these vacations, downline distributors are pressurised to buy many products.399

397 Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 25.
398 The disclaimer reads as follows, ‘[w]hen considering or comparing business opportunities please be aware that it is illegal for a promoter or participant in a trading scheme to persuade anyone to make a payment by promising benefits from getting others to join a scheme. Do not be misled by claims that high earnings are easily achieved’ and can be found on the South African website available at http://businessopportunity.herbalife.co.za/ (accessed on 21 November 2018).
399 Criticisms about Herbalife’s compensation plan can be found on the Facts About Herbalife website available at https://www.factsaboutherbalife.com/the-facts/the-herbalife-compensation-plan/ (accessed on 8 November 2018).
40(1) of the CPA includes pressure as a form of unconscionable conduct. However, as mentioned in Chapter 3, it is difficult to determine when pressure will amount to unconscionable conduct that cannot be covered under any of the other section 40(1) grounds. It can thus be argued that this kind of pressure placed upon Herbalife distributors fits the definition of coercion. The same can be said in the following situation. The FTC was alert to the fact that Herbalife forced distributors to buy products in bulk so that they could benefit from greater wholesale discounts. Although the FTC found that this amounted to pressure, it is possible that, under section 40 of the CPA, such conduct would constitute coercion.

Moreover, the current pending litigation against Herbalife in the United States is centred around the allegation that Herbalife coerced members into attending numerous ‘Circle of Success’ events. If these allegations have any merit, this will also amount to unconscionable conduct, in the form of coercion, under the CPA. Owing to the similarity between the definition of coercion and duress, Herbalife’s conduct in the different situations discussed above could possibly also fall under duress.

Section 40(2) of the CPA is similar to section 5 of the FTC Act. Section 40(2) precludes Herbalife distributors from consciously taking advantage of a consumer who is substantially incapable of protecting their own interests. One reason for this may be a consumer’s ignorance. If the consumer is uneducated in general or uneducated about the Herbalife business opportunity, and the distributor, who despite being aware of this fact uses it to their own benefit, this could amount to unconscionable conduct.

Although sections 40(1) and 40(2) provide a list of conduct that is considered unconscionable, this list is not exhaustive, hence, Herbalife and its representatives need to abstain from all forms of unethical and improper conduct.

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401 Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 22.
402 Fin 24 ‘Herbalife distributors claim in $1 billion lawsuit that “success” events were a sham’ 21 August 2018 available at https://www.fin24.com/Economy/herbalife-distributors-claim-in-1-billion-lawsuit-that-success-events-were-a-sham-20180821 (accessed on 11 October 2018).
403 According to section 5 of the FTC Act, ‘an act or practice is unfair where it (1) causes or is likely to cause substantial injury to consumers, (2) cannot be reasonably avoided by consumers and (3) is not outweighed by countervailing benefits to consumers or to competition’.
5.5 Herbalife and sections 29, 41 and 48 of the CPA

Like section 40, section 41 of the CPA bears similarity to section 5 of the FTC Act. In order to ensure compliance with sections 29 and 41 of the CPA, neither Herbalife nor its distributors must convey false, misleading or deceptive representations to consumers whilst marketing Herbalife products. Furthermore, section 41(1)(c) read with section 41(2)(b) mandates that they correct any misapprehension which consumers have which can be construed as being a false, misleading or deceptive representation.

A major flaw in Herbalife’s Sales and Marketing Plan, as pointed out by the FTC, was the representations it gave distributors regarding their financial prospects of success. The various forms of marketing and promotional material used by the company led distributors to believe that they could earn a significant income either part-time or full time.404 This differed from reality where only a few distributors benefitted substantially whilst most generated only a small income (if at all) or experienced a loss.405 Herbalife’s 2017 Statement of Average Gross Compensation contains a disclaimer regarding potential earnings.406 However, as noted by the FTC in its investigation, these disclaimers do not change the general message portrayed by Herbalife, that is, that its members can earn a substantial income.407

Herbalife also created the impression that distributors earn a significant income from the sale of Herbalife products.408 This can be regarded as a false representation because, as discussed previously, the main source of a distributor’s income stems from recruitment.409 However, in light of the fact that Herbalife has since placed a

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404 Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 4-5.
405 Ibid 38.
406 The disclaimer reads as follows, ‘[t]he compensation summarized below is not necessarily representative of the compensation, if any, that any particular Member will receive. These figures should not be considered as guarantees or projections of your actual compensation or profits. Success with Herbalife Nutrition results only from successful product sales efforts, which require hard work, diligence and leadership. Your success will depend upon how effectively you exercise these qualities’.
407 Federal Trade Commission v Herbalife International of America Inc Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 5.
408 Ibid 14.
greater focus on retail sales by complying with the 80% threshold set by the FTC, it can be argued that this representation is no longer inaccurate.\textsuperscript{410}

Another way in which Herbalife members are deceived or misled is through the promotion of nutrition clubs. Members are given the idea that nutrition clubs earn a substantial sum of money for the club owner, however, the FTC investigation revealed otherwise.\textsuperscript{411}

Owing to the discrepancy between what Herbalife asserted and what actually transpired, the abovementioned claims could be viewed as false, deceptive or misleading representations under section 41 of the CPA. In terms of section 48 of the CPA, if there is a false, misleading or deceptive representation by Herbalife or its distributors which a consumer acts upon to their detriment, the resulting contract will be unfair, unreasonable or unjust. A contract between Herbalife and a consumer will also be unfair, unreasonable or unjust if Herbalife or its distributors make a statement of opinion and the consumer's reliance thereon negatively impacts upon them.\textsuperscript{412} If the contract is as a result of unconscionable conduct or false, misleading or deceptive representations, the consumer can approach a civil court.\textsuperscript{413} If the court finds that the consumer's allegations are correct, it will decide on an appropriate remedy such as ordering Herbalife to restore the consumer's money as well as recom pense the consumer for any loss suffered.\textsuperscript{414}

5.6 The consequences Herbalife can face if it engages in prohibited conduct

It is the responsibility of the NCC to investigate any complaint it receives which alleges that Herbalife is engaging in prohibited conduct stipulated in sections 43, 40 or 41. Should the NCC find these allegations to be correct, it may issue a compliance notice to Herbalife.\textsuperscript{415} The notice will stipulate how Herbalife has breached the CPA and how

\textsuperscript{411} \textit{Federal Trade Commission v Herbalife International of America Inc} Case No. 2:16-cv-05217 Complaint for Permanent Injunction and Other Equitable Relief, 15 July 2016 page 20.
\textsuperscript{412} Section 48(2)(c).
\textsuperscript{413} Section 52.
\textsuperscript{414} Section 52(3).
\textsuperscript{415} Section 100(1).
Herbalife can rectify this, usually within a specified time. Alternatively, within the specified time, Herbalife can bring forth reasonable evidence indicating that it did not engage in conduct prohibited under the CPA.

Should Herbalife fail to act in accordance with the notice, the matter can be referred to either the NPA for prosecution or the NCT. The NCT has the power to impose an administrative fine. The orders which the NCT can make if Herbalife is found guilty of engaging in a prohibited practice under the CPA are those set out in section 150 of the National Credit Act. This includes declaring Herbalife’s conduct as prohibited, issuing an interdict against Herbalife and imposing an administrative fine on Herbalife. The fine can be equivalent to 10% of Herbalife’s annual turnover in the previous year or R1 000 000, whichever amount is higher. Herbalife’s failure to comply with an NCT order may result in a fine or imprisonment for not more than 10 years or both.

5.7 Herbalife and the common law

In addition to section 41 of the CPA, the common law also precludes Herbalife from making misrepresentations. If Herbalife makes a false representation, the purpose of which is to defraud consumers, and which prejudices or which can prejudice consumers, then Herbalife’s conduct will be tantamount to the common law definition of fraud. Herbalife’s inaccurate statements regarding the potential earnings its members could expect to receive can be regarded as being prejudicial or potentially prejudicial because it was contrary to reality where the business opportunity was profitable to only a few while most derived no profits or incurred a loss. If Herbalife members joined the company because they were misled by these fraudulent

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417 Ibid.
419 Act 34 of 2005. The NCT was established by the National Credit Act (NCA) and its powers and functions were extended when the CPA came into operation in 2011. Therefore, in order to ascertain the powers and functions of the NCT it is necessary to consider the relevant sections of the NCA as these are not re-iterated in the CPA.
420 Section 151(2) of the NCA and section 112(2) of the CPA.
421 Section 160 read with section 161 of the NCA.
representations, they are entitled, under the common law, to take legal action against Herbalife and to claim damages.\textsuperscript{422}

5.8 Conclusion

It is apparent that the manner in which Herbalife operates in South Africa mimics its operation in the United States. Under South African law, Herbalife is prohibited from operating a pyramid scheme. An analysis of Herbalife's Sales and Marketing Plan through the lens of the CPA leads to the conclusion that Herbalife's focus on incentivising recruitment, as opposed to retail sales, prior to the FTC investigation, would render it a pyramid scheme under the section 43(4)(a) definition. However, Herbalife has since increased its retail sales to external consumers to over 80%. Nevertheless, by promoting the Herbalife opportunity in a manner that emphasises recruitment and by determining a member's progress and compensation based on recruitment, Herbalife can still amount to a pyramid scheme under section 43(4)(b). However even if the NCC, following an investigation into Herbalife, finds otherwise, Herbalife is unlikely to escape liability. This is because the NCC is entitled to investigate all forms of prohibited conduct and not just the promotion of, and participation in, pyramid schemes.

Herbalife's conduct and representations made while promoting the scheme and attempting to enlist new members may constitute unconscionable conduct under section 40 of the CPA and/or false, misleading or deceptive representations under section 41. As with all forms of prohibited conduct investigated by the NCC, Herbalife may be issued a compliance notice. Failure to adhere thereto may have further consequences as the matter may then be prosecuted by the NPA. Alternatively, the NCT may impose an administrative fine on Herbalife.

\textsuperscript{422} Melville \textit{The Consumer Protection Act made easy} 2 ed (2011) 55.
CHAPTER 6
CONCLUSION AND RECOMMENDATIONS

6.1 Conclusion

This research was undertaken with the intention of determining whether Herbalife is a legitimate MLM company or an illegal pyramid scheme under South African law, which has specific legislation dealing with pyramid schemes. The reason for embarking on this research stems from the numerous allegations against Herbalife in other jurisdictions, most notably the United States, where the FTC declared Herbalife to be a legitimate business model but ordered that certain changes be made and that consumers who had been misled be compensated.

This research has demonstrated that there is a very fine line between legitimate MLM companies and illegal pyramid schemes, especially when a legitimate product is involved, and it is in this case not easy to make a definitive finding one way or the other. This is also demonstrated by the NCC’s inability to make findings on so many of the schemes that it has commenced investigating.\textsuperscript{423} It is evident from this research that Herbalife does sell legitimate products which are beneficial to consumers, particularly athletes and those seeking to maintain a healthy lifestyle. The cost of Herbalife Member Packs is also, arguably, reasonable and proportionate to what members receive in return, namely, the packs themselves and the opportunity to pursue the business opportunity. Furthermore, Herbalife adopts a buyback policy. These features of Herbalife’s business model indicate that Herbalife really does resemble an MLM. However, there are other aspects of the business model which are questionable, particularly the issues around the compensation plan and the amount of money that can be made from participating in the scheme.

To amount to a pyramid scheme under the CPA, an arrangement, agreement, practice or scheme must compensate its participants primarily for recruitment, or, while promoting, it must emphasise that recruitment is the primary form of compensation.

\textsuperscript{423} Information regarding the NCC’s decision to decline reporting on certain schemes which it had investigated can be found on the Behind MLM website available at https://behindmlm.com/companies/world-ventures/nccs-worldventures-findings-will-not-be-made-public/ (accessed on 10 January 2019).
Majority of Herbalife’s product sales (about 80%) is to consumers who are not Herbalife recruits.\textsuperscript{424} Furthermore, the South African Herbalife website expressly warns against the promotion of Herbalife in a way that emphasises recruitment.\textsuperscript{425} It can thus be concluded that Herbalife does not conform to the section 43 definition of a pyramid scheme hence, it is not a prohibited scheme under the CPA. However, even though Herbalife may avoid being termed a pyramid scheme, it may not escape liability altogether. By misrepresenting to members the income they can expect to receive and by pressurising recruits to purchase products or attend events under the misapprehension that this will better their income, Herbalife is guilty of engaging in other forms of conduct deemed prohibited by the CPA.

6.2 Recommendations

The following recommendations are proposed:

• In order to remain clear of being labelled a pyramid scheme, Herbalife must strive to maintain the threshold requirement of 80% of sales to external consumers thereby attempting to ensure that members receive more money from retail sales as opposed to recruitment. Furthermore, during promotion of the scheme, retail sales, and not recruitment, must be emphasised as being the main source of a member’s income.

• Herbalife must proceed cautiously and be mindful of how it promotes its business opportunity to potential recruits so as to ensure that it is not engaging in other forms of proscribed conduct. The company must be clear in the message it sends out and make certain that, going forward, it makes accurate representations and provides recruits with a realistic expectation of their potential earnings. This can be done by keeping records and furnishing recruits with these records to enable them to make an informed decision regarding whether or not to join the Herbalife opportunity.


\textsuperscript{425} The warning, which is in the form of a disclaimer, is available at http://businessopportunity.herbalife.co.za/ (accessed on 21 November 2018).
The Herbalife company enjoys global success, however, its existence in South Africa may come to an untimely demise if it promotes its business opportunity in a manner that is tantamount to prohibited conduct under the CPA.
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Annexure A: Ethical Clearance Certificate

3 September 2018

Miss Johara Deen Ally 214547721
School of Law
Howard College Campus

Dear Miss Ally

Protocol reference number: HSS/1412/018M
Project title: A critical examination of Herbalife’s business model in order to determine whether it is a prohibited scheme under the Consumer Protection Act 68 of 2008

FULL APPROVAL – No Risk/Exemption Application

In response to your application received 2 August 2018, the Humanities & Social Sciences Research Ethics Committee has considered the abovementioned application and the protocol has been granted FULL APPROVAL.

Any alteration/s to the approved research protocol i.e. Questionnaire/Interview Schedule, Informed Consent Form, Title of the Project, Location of the Study, Research Approach and Methods must be reviewed and approved through the amendment /modification prior to its implementation. In case you have further queries, please quote the above reference number.

PLEASE NOTE: Research data should be securely stored in the discipline/department for a period of 5 years.

The ethical clearance certificate is only valid for a period of 3 years from the date of issue. Thereafter Recertification must be applied for on an annual basis.

I take this opportunity of wishing you everything of the best with your study.

Yours faithfully

................................................................................................................
Professor Shenuka Singh (Chair)
Humanities & Social Sciences Research Ethics Committee

/pm

cc Supervisor: Professor TA Woker
cc. Academic Leader Research: Dr Shannon Bosch
cc. School Administrator: Ms Robynne Louw/ Mr P Ramsewak

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