

PYRAMID SCHEMES:

Saving the network marketing industry by defining the gray

by

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I. INTRODUCTION

In these trying economic times, responsible network marketing companies are positioned to offer viable opportunities for people that desperately need them. They combine passion for products with individual ambition to create a powerful testimony to the unyielding principles of free enterprise. With a fair compensation plan, an exciting product, and proper education, independent agents across the globe (also referred to as distributors) can leverage the power of networking to dramatically change their financial circumstances. Network marketing companies are responsible for providing its distributors with marketable products and compensation plans that rewards and motivates the sales force. Ideally, the rewards are designed to be commensurate with the work performed. With a good product and a fair compensation plan,

the average person is given an opportunity to completely redefine their finances while operating a home based business.

Distributors earn income primarily in two ways. First, they can purchase products at wholesale and mark them up for retail sales, thus earning an immediate profit. Secondly, they can form a “downline” by recruiting additional distributors and earn commissions on their sales to customers and purchases for personal use. Since distributors are paid commissions on sales made at “multiple levels” down a fixed sales organization, network marketing is commonly referred to as multilevel marketing.

In his book titled The New Professionals, authors Charles King and James Robinson highlight the historical roots of direct sales. The roots of direct selling can be traced back to the colonial peddlers selling various goods door to door.¹ Until transportation

improved, peddlers were an important distribution channel in serving a geographically dispersed market.² Although the rise of general stores seemed to end the relevancy of peddlers, various manufacturers sought exclusive arrangements with direct sellers to differentiate themselves from the competition.³ As noted in King and Robinson's book, "Manufacturers tried to recapture the advantages of personal selling . . . but under conditions that gave them some measure of control."⁴

The industry has evolved considerably since its early days. The history of the industry would be incomplete without reference to one of the largest network marketing giants in history: Amway. The founders of Amway, Rich DeVos and Jay VanAndel, began their careers in direct sales by selling Nutrilite multivitamins to health conscious consumers in the early 1950s.⁵ Rich and Jay quickly became two of the most successful distributors in the country. In the late 1950s, due to issues within the company, Rich and

Jay left Nutrilite and started The American Way Association in their basements. “Amway” would eventually become its official name. In 1999, Amway changed its name to Quixtar in North America. In May of 2009, the name [will change back to Amway](#).⁶

During the evolution of the network marketing industry, there have been some irresponsible companies that have strayed from the roots of direct sales. Instead, these companies chase a quick dollar while placing product sales secondary to recruitment efforts. For example, suppose there’s a network marketing company that sells tap water at \$100 per bottle. Theoretically, distributors could purchase this water and mark it up to \$120 per bottle for retail sales, thus earning an immediate \$20 profit. Since there

would be very little demand for this expensive water, it would be unlikely that people unaffiliated with the business would buy the water at \$120. Instead, distributors could focus on recruiting other distributors and encourage them to buy the water for

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Ask yourself, if there was no monetary opportunity associated with the product, would you still buy it as a customer?

themselves (“personal consumption”) and recruit other distributors to do the same. As a result of this evolution, there is a proliferation of recruitment based pyramid schemes, also referred to as endless chain schemes. There’s a fine line that separates legitimate network marketing companies from pyramid schemes. There’s an easy way to tell a difference: trust your instincts. Ask yourself, if there was no monetary opportunity associated with this product, would you still buy it as a

customer? If the answer is “yes,” odds are you’re not alone and you’ve found a good company with a marketable product. But if the answer is “no,” walk away and count yourself lucky.

The network marketing industry is largely unregulated, which has led to abuse by pyramid scheme promoters as they prey on the aspirations of unsuspecting consumers. Currently, the industry is on fire over the issue of recruitment versus retail sales. What’s the appropriate mix between recruitment efforts and selling efforts? The two factors are not one in the same. In the past two years alone, four class action lawsuits have been filed by consumers against prestigious companies in the industry, two of them against Amway.⁷ The recurring theme in the lawsuits is that the companies are focusing predominantly on recruiting additional distributors that purchase products for themselves instead of selling products to customers outside the organization, also referred to as non-

participants. With so many consumers crying foul, it's puzzling to see federal regulators and state Attorney Generals, with the exception of [Florida](#) and [California](#), disengaged from the problem.⁸

In [Woodward, et al v. Quixtar](#), which was a class action lawsuit filed against Quixtar, the plaintiffs attached an exhibit that allegedly illustrates the percentage of Quixtar's revenue that's attributable to customer sales.⁹ The plaintiffs alleged that only 3.4% of Amway's total revenue in North America came from sales to nonparticipants.¹⁰ In North America, Amway cleared \$1.118 billion in 2006.¹¹ Humor me for a second and assume there's a network marketing company out there that can only attribute 3.4% of revenue to customer sales. In order to put this in perspective, imagine driving by a McDonalds and you read the sign that says, "Over 100 billion sold." Now imagine a footnote that says, "96.6 percent of the burgers were purchased and consumed by

franchise owners.” It would make for a great joke, but this sad truth plagues many companies in the network marketing industry. If there was such a sign, people would immediately ask, “If the hamburgers are so good, why aren’t non-owners buying them?” In addition to the 3.4% statistic, Amway produces a “Platinum Index” report for its qualified leaders.¹² In its 2002 report, Amway reported an average of .23 registered customers per distributor, which equates to one customer per four people. Assuming the 3.4% allegation to be true, which Amway has contested, the vast majority of Amway’s volume would be generated from its sales force.¹³ However, Amway has recently employed drastic measures to increase their customer sales. These measures will be discussed in more detail later.

It is referred to as opportunity driven demand. Opportunity driven demand means distributors are incentivized by the company’s sales leaders and compensation plan to

buy and consume certain quantities of product each month and recruit additional participants to do the same. The practice of distributors buying products for themselves (not for resale) and recruiting additional participants to do the same is referred to as



Since products are typically costly in pyramid schemes, product flow to bona fide customers is almost non-existent



“internal consumption.” Instead of earning profits realized from sales to nonparticipants, the distributors aim to earn commissions on the volume generated by their ever expanding number of downline distributors via personal consumption. The opportunity to earn income places distributors “under the influence” and motivates them to purchase products they otherwise would never purchase at prices they would never pay. In this scenario, product volume stems primarily from internal consumption and fills the chain with distributors buying overpriced products while incentivizing them to recruit other participants to keep the scheme afloat.

In pyramid schemes, the products are hopelessly overpriced, leaving sufficient margins to pay commission to distributors up the chain, which leads to distributors being fraudulently induced into participating in an endless chain scheme.

When the emphasis is on the opportunity, it can lead to a culture of overstatement.¹⁴ In The New Professionals, the authors write, “This hard sell promised not only a decent product and a good income but also an opportunity to change lives, overcome addictions, repair failing marriages, revitalize America, and change the world! The ‘sales story’ had to be charismatic, captivating, and compelling to close the sale and keep recruits motivated. Exaggeration and hyperbole were the tone of the day.”¹⁵

Network marketing gets a bad reputation when people make product consumption synonymous with patriotism and civic virtue.¹⁶ When the charismatic messages of fulfillment and restoration dwarf the product story, there might be a problem. If you

find yourself confused by a speaker's message, go back to the product and make a gut check as to the value. Ask yourself if you can earn the represented income by primarily selling products to customers at retail.

With this article, I illustrate the nature of pyramid schemes and articulate the cumbersome laws governing the industry.

Compensation Plans

The network marketing industry has its own lexicon. It can be confusing with terms like downline, upline, business volume, group volume, line of sponsorship, matrix, etc. Despite the complicated terminology, it's very important to understand the general concepts behind network marketing compensation plans. For better or worse, compensation formulas incentivize distributor behavior. As with Pavlov's dog, people's

behavior is shaped by a series of rewards and punishments. Although the structure and terminology of compensation plans vary, they all provide distributors with multiple opportunities for income. Distributors earn income primarily in two ways. First, they can sell products to nonparticipants. Second, they can earn commissions driven by the sales of those they recruit, and the recruits of recruits. Recruits in a distributor's organization are often referred to as the "downline." "Upline" refers to the members above a distributor in the "line of sponsorship," or genealogy. Since there are multiple ways of earning income, the efforts of distributors are divided between selling products at retail on the one hand and pitching the opportunity to potential recruits on the other. If the compensation plan produces a system of monetary rewards that decisively favors recruitment over sales, the field will focus on recruiting. Recently in Utah, the District Court held, "The promise of lucrative rewards for recruiting others tends to induce

participants to focus on the recruitment side of the business at the expense of their retail marketing efforts, making unlikely that meaningful opportunities for retail sales will occur.”¹⁷ Rather than relying on product sales to nonparticipants, companies relying on massive recruitment and internal consumption hint at the existence of an endless chain scheme.

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II. PYRAMID SCHEMES

The FTC has recently admitted it is very difficult to distinguish between a legitimate network marketing company and an illegal pyramid scheme. In their [proposed business opportunity rule](#) published in late 2007, the FTC made the comment, “[W]hile there is a significant concern that some pyramid schemes masquerade as legitimate MLMs, assessing the incidence of such practices is difficult.”¹⁸ The FTC further states, “While economic analysis can reveal if an individual company clearly is operating legitimately or if it clearly is a pyramid scheme, *it is difficult to draw an appropriate line in the gray area.*”¹⁹ Unfortunately, the FTC’s failure to develop a bright-

line standard distinguishing legitimate companies from illegal pyramids is enabling pyramid promoters to declare open season on consumers, which negatively affects the reputation of the entire industry. The FTC has stated they wish to continue pursuing pyramid schemes on a case-by-case basis.²⁰ In an industry with hundreds of network marketing companies launching each year, the case-by-case approach might prove ineffective at curbing inappropriate marketing tactics. Due to the size of this “gray area,” it’s as if the majority of network marketing companies are a herd of gazelles running from the regulatory lions with each company trying to outrun the slowest.

In 1975, the Federal Trade Commission established a two-pronged test for determining what constitutes a pyramid scheme. The test is still used today. In the case In re Koscot Interplanetary, Inc, the court held, “[Pyramid] schemes are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product *and* (2) the right to receive in return for recruiting other participants into the program rewards which are *unrelated to the sale of products to ultimate users*.”²¹ “Pyramid schemes are said to be inherently fraudulent because they must eventually collapse.”²² According to the Ninth Circuit, the right to receive rewards for recruitment is the *sine qua non*, or determining factor, of a pyramid scheme. *Sine qua non* is Latin for “without which there



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is nothing.” The court held, “As is apparent, the presence of the second element, recruitment with rewards unrelated to products sales, is *nothing more than an elaborate chain letter device* in which individuals who pay . . . with the expectation of recouping it to some degree via recruitment . . .”²³

The interpretation of the second element is THE divisive issue. The debate hinges on the definition of “ultimate user,” also referred to in the industry as “end user.” As stated earlier, internal consumption occurs when distributors purchase products for their personal use and recruit additional distributors to do the same. It’s called “internal consumption” because the volume is generated internally by the sales force, not externally via nonparticipants. When commissions are paid on downline volume regardless if it comes from distributor consumption or customer sales, distributors can effectively build a “buyer’s club” and focus exclusively on recruiting additional

distributors and encourage them to buy for themselves. Remember, commissions are usually calculated based on what a distributor purchases. In this case, the rewards are not tied to what the distributor re-sells, which enables distributors to purchase for self-use and recruit others to do the same. According to supporters of this logic, purchases made by the sales force should count as “end users” in satisfaction of the Koscot test. They argue if distributors purchase products with the intent to consume, without the intent to resell, they should be considered “end users.”²⁴ The Direct Selling Association (“DSA”), the largest trade association of network marketing companies, supports this position.²⁵ Amway, Mary Kay, Avon, Herbalife, Shaklee and Melaleuca are some of its most notable members.

Contrary to the DSA’s position on internal consumption, a case from the Ninth Circuit and various FTC Orders states that pyramid schemes exist when distributors purchase

products with the intent of earning income primarily by recruiting additional participants to do the same. [As stated by the general counsel of the FTC](#), “No program can recruit new members forever.”²⁶ With this recruitment-heavy approach, products are viewed as mere tokens disguising the pyramid scheme where money is simply transferred from the base of the pyramid to earlier investors.²⁷ Think Bernie Madoff but with a token product. The FTC, who has been caught on both sides of the same issue, has said, “[A] pyramid scheme simply transfers monies from losers to winners. For each person who substantially profits from the scheme, there must be many more losing all, or a portion, of their investment to fund those winnings.”²⁸

In Koscot, the defendants were selling cosmetics via network marketing and held weekly opportunity meetings emphasizing the unlimited earnings potential by recruiting other participants into the program.²⁹ The court held that the opportunity meetings created “a

highly-charged emotional atmosphere in which prospects were persuaded that Koscot offered a fantastic opportunity to ‘achieve financial success beyond [their] greatest expectation’³⁰ The court held Koscot to be an illegal pyramid scheme and stated,

[Defendants’] multilevel marketing program . . . contemplates an endless recruitment of participants since each person entering the program must bring in other distributors to achieve the represented earnings. *The demand for prospective participants thus increases in geometric progression whereas the number of potential investors available in a given community or geographical area remains relatively constant.*³¹

Peter Vander Nat, senior economist for the FTC, co-wrote an article in 2002 titled Marketing Fraud: An Approach for Differentiating Multilevel Marketing from Pyramid Schemes. In the article, the authors cited various FTC settlement orders and stated, “The FTC settlements reflect the following position. . . [T]he organization is deemed a pyramid scheme if the participants obtain their monetary benefits *primarily* from

recruitment rather than the sale of goods and services to consumers.”³² Since the FTC will not take an industry-wide stance on the definition of “end user” or “customer,” there’s ample wiggle room for companies in the industry to argue in favor of compensation plans geared towards heavy recruitment and minor customer sales. As a result of this struggle between the network marketing industry and consumer advocates, there is a split in authority across the country over the definition of “end user” as it pertains to Koscot.

III. SPLIT IN AUTHORITY

Since Koscot, there has been no other court opinion with a greater impact in the network marketing industry than Webster v. Omnitrition International.³³ In Omnitrition, the Ninth Circuit court of appeals rendered a decision that challenged the recruitment model relied upon by endless chain schemes. Distributors brought suit against the company trying to invalidate the contract on the grounds that Omnitrition was an illegal pyramid scheme. Utilizing the Koscot test, the Ninth Circuit sided with the plaintiffs.

In Omnitrition, the distributors marketed nutritional supplements through a multilevel marketing program. Its distributors could purchase products at discount and sell at retail for an immediate profit. In defense of the pyramid allegations, Omnitrition argued that they had policies in place that encouraged retail sales.³⁴ These policies are referred to as

the “Amway Safeguards,” referencing the rules utilized by Amway in the 1970s that were instrumental in their survival of a FTC enforcement action. In Omnitrition, the distributors were required to certify they resold seventy percent of the products they purchased to customers.³⁵ The “seventy percent rule,” one of the Amway Safeguards, is designed to encourage retail sales. As the court noted, it takes more than having a policy to survive scrutiny. The Court held, “The existence and enforcement of rules like Amway’s is only the first step in the pyramid scheme inquiry. . . . There *must be evidence that the program’s safeguards are enforced and actually serve to . . . encourage retail sales.*”³⁶ In other words, to misquote an anonymous speaker, “The road to hell is paved with good intentions.” Omnitrition argued that distributor purchases for personal use should count as “sales” in satisfaction of their seventy percent rule. The court rocked the network marketing industry by stating, “If *Koscot* is to have

any teeth, *such a sale cannot satisfy the requirement that sales be to "ultimate users" of a product.*"³⁷ In other words, Omnitrition was found to be a



In an effort to curb endless recruitment and force companies to offer marketable products, the Ninth Circuit requires network marketing companies to accrue sales from nonparticipants.

pyramid scheme because they **lacked sufficient sales to customers outside the distributor network.** If you will recall in Koscot, the court held, “[Defendants’] multilevel marketing program . . . contemplates an endless recruitment of participants since each person entering the program must bring in other distributors to achieve the represented earnings.”³⁸ The Ninth Circuit determined that the Koscot test would be meaningless if

distributors were considered “ultimate users,” as it would allow network marketing companies to focus exclusively on recruitment.

In several of their enforcement actions against various pyramid schemes, the FTC uses the Omnitrition decision as its billy-club to support its arguments.³⁹ In Federal Trade Commission v. Trek Alliance, the stipulated final Order defines an illegal pyramid scheme as a plan in which distributors pay for the right to receive rewards “unrelated to the sale of products or services to persons *who are not participants in the marketing program.*”⁴⁰ In other words, compensation must be driven primarily by sales to nonparticipants, not by purchases from the sales force. In numerous other cases brought by the FTC, similar definitions were applied.⁴¹

While the FTC's position on pyramid schemes seems clear, it appeared to contradict itself in an Advisory Opinion in 2004 addressed to the Direct Selling Association. The FTC stated that the language found in its consent orders do not "represent the state of the law for the general public."⁴² In its Advisory Opinion, which pre-dates Trek, the FTC wrote,

In fact, the amount of internal consumption in any multi-level compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme. The critical question for the FTC is whether the revenues that primarily support the commissions . . . are generated from purchases of goods and services that are not simply incidental to the purchase of the right to participate in a money-making venture. A multi-level compensation system funded primarily by such non-incidental revenues does not depend on continual recruitment of new participants. . ."⁴³

The critical question, as explained in their Advisory Opinion, is whether the product is a mere token of an illegal scheme. As stated by the FTC, it takes more than selling

products to be considered legitimate. In the same letter, it states, “*The Commission’s recent cases, however, demonstrate that the sale of goods and services alone does not necessarily render a multi-level system legitimate.*” Modern pyramid schemes generally

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do not blatantly base commissions on the outright payment of fees, *but instead try to disguise those payments to appear as if they are based on the sale of goods or services.*”⁴⁴ When products lack legitimate market value and the only market is the sales force, and success in the business requires finding additional sales people to buy products and recruit, there might be an endless chain scheme. We’re back to the

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McDonald’s analogy mentioned in the introduction. If 96.6% of all hamburgers were consumed by franchise owners instead of customers, would you want to buy one?

Omnitrition was decided in 1996. What once appeared to be the death knell of heavy recruitment companies has failed to establish itself as well settled law. As stated earlier, there is a struggle between members of the network marketing community and consumer advocates causing a split in authority across the country over the definition of “end user.” [The DSA has led lobbying efforts](#) in the United States Congress and in several states to pass legislation that legitimizes compensation plans driven primarily by internal consumption instead of sales to nonparticipants.⁴⁵ As an example, in Utah the anti-pyramid statute prohibits compensation derived from the introduction of other people into the scheme.⁴⁶ In its definition of “compensation,” the statute states, “‘Compensation’ does not include payment based on the sale of goods or services to anyone purchasing the goods or services *for actual personal use or consumption.*”⁴⁷ In layman’s terms, a company can be driven primarily by recruitment and have 0% in

customer sales and never be bothered in Utah. The statute is in direct contrast to the Omnitrition case and several FTC Orders.

Congressional Bill, H.R. 1220

In Congress, the DSA has supported a bill titled “Anti-Pyramid Promotional Scheme Act of 2003,” also known as HR 1220.⁴⁸ The bill has yet to pass and likely never will pass. The bill is similar to the Utah statute and creates an exception for paying commissions derived primarily from distributor purchases rather than sales to nonparticipants. The proposed bill states,

Nothing in this Act . . . shall be construed to prohibit a plan or operation . . . based upon the fact that [distributors] in the plan or operation give consideration in return for the *right to receive compensation based upon purchases of goods . . . by [distributors] for personal use, consumption, or resale, and the plan or operation does not promote inventory loading and implements an appropriate inventory repurchase program.*⁴⁹

The “appropriate inventory repurchase program” referenced above refers to a proposed twelve month return policy.⁵⁰ In support of this Bill, the DSA submits, “[T]here are huge differences [between illegal pyramid schemes and legitimate network marketing companies]. Primary among these differences is that the products and services sold by legitimate multilevel marketing companies *are in fact used or consumed*, and compensation is based upon those sales for consumption by the end-user.”⁵¹ The bill is designed to legitimize compensation plans driven primarily from internal consumption rather than by sales to nonparticipants. In other terms, the bill seeks to eliminate the distinction between internal consumption and sales to nonparticipants.

So do you believe me now?

Clearly, the law in network marketing world is a mess. While Koscot seems clear, there's ample wiggle room over the definition of "end user." Unfortunately for consumers, the law is not developing appropriately in the industry to create uniformity. Since most network marketing companies institute arbitration agreements with their distributors, the disputes that arise end up in confidential arbitration with no precedential value.⁵² In an industry with much room for consumer abuse, individual states must implement simple safeguards to effectively curb endless chain schemes disguised as legitimate network marketing opportunities. Illegitimate schemes must be rooted out in order to preserve the perception and integrity of the entire industry.

Arguments in favor of counting distributors as "end-users"

On its website, the DSA has published results of a 2006 survey indicating that 29% of people join network marketing companies to enjoy the wholesale pricing. Remember, distributors can buy at wholesale and sell at retail for an immediate profit. Since the barrier to entry is usually low with low registration fees,⁵³ people can conceivably become distributors to take advantage of price breaks. If distributors are purchasing products for the inherent value without the intent to recruit additional participants, it raises the problem of discerning between distributors building a business and bona fide customers. However, in another survey, the DSA reported that “85% of direct sellers report that network marketing meets or exceeds their expectations as a good way to supplement their income.”⁵⁴ Confused? So am I. If 29% of people become distributors to take advantage of price breaks, not to earn income, I’m not sure how 85% of distributors can be happy with the model as a way to supplement their income? It’s

important to remember that the DSA is in business to keep network marketing companies in business.⁵⁵ In their defense, the 85% figure might have been the result of a more recent survey.

In my opinion, exit-surveys would provide valuable data as to why distributors quit and why they joined in the first place. The results might be more credible, as the euphoria of joining an “opportunity of a lifetime” would have waned by the time of exit.

In response to the “buyer’s club” logic referenced above where distributors recruit other distributors for the price breaks, it is important to note that the vast majority of distributors quit the program within the first year. In a survey conducted by the DSA between 1997 and 1998, the average turnover rate between its members’ distributors was 56%, which means approximately 56% of all distributors quit every year.⁵⁶

Additionally, another survey found the turnover rate to be 100% at four prestigious network marketing companies, specifically Mary Kay Cosmetics, Saladmaster, Tupperware, and United Consumers Club.⁵⁷ If people are seriously joining network marketing companies to enjoy the price breaks, one has to wonder the reasons behind



these large attrition rates.

In some companies, the attrition rate is as high as 90% after the first three years in the business.



In addition to the fact that distributors may sign up to take advantage of product discounts, companies argue that distributor purchases should count as customer sales because the distributors might be buying products and physically selling them to customers. The person to person transaction is

the origin of the term “direct sales.” If a distributor purchases product, it’s hard to determine if he or she is consuming the product or physically selling it to customers.

The vast majority of network marketing companies have rules requiring their distributors to “certify” each month that a minimum amount of product purchased was sold to customers. As an example, in order for Amway distributors to collect a bonus, they must certify that they sold fifty points worth of product to customers (people unaffiliated with Amway), which is roughly between \$100 and \$150 worth of products.⁵⁸ Many network marketing companies like Amway rely on the honor system and allow distributors to “self-report” their customer sales.⁵⁹ If a distributor purchased over one-hundred points of product a month and sold nothing to customers, they could, theoretically, self-report customer sales and be eligible for their bonus. Since the field of distributors is so substantial, it’s understandably a difficult policy to police. The FTC is aware of this practice as they wrote in the revised business opportunity rule, “[Retail sales rules] could go unenforced, or even if they were ostensibly enforced, could be

circumvented by distributors, who may have an incentive to ‘certify’ their sales in order to qualify for higher bonuses. Indeed, the potential *collusion between MLM companies and distributors to fake the true level of retail sales* would undermine the utility of [our proposed rule].”⁶⁰ As stated earlier, it takes more than the presence of rules to survive scrutiny. The rules must be effectively enforced and actually lead to retail sales.⁶¹ The honor system method used by companies poses a challenge for regulators to discern the difference between purchases made with the intent to consume, purchases made with the intent to sell, and purchases made with the intent to consume in the hopes of recruiting other people to reciprocate.⁶²

IV. AMWAY: IT TAKES A LICKIN’ AND KEEPS ON TICKIN’

In King and Robinson’s book, they state, “Look at virtually any aspect of the rise and development of network marketing and you will see Amway’s fingerprint.”⁶³ In the late 1970s, the Federal Trade Commission began looking at Amway’s business model to determine whether it was operating as an illegal pyramid scheme.⁶⁴ The case was decided in Amway’s favor and became the backbone of the network marketing industry. The FTC determined Amway was not a pyramid scheme because they had policies in place that encouraged retail sales and prevented distributor abuse. These policies adopted by Amway became known as

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the *Amway Safeguards*.⁶⁵ The safeguards designed to encourage retail sales are as follows:

- a. **The Ten Customer Rule**—The *Amway* ten customer rule stated that “distributors may not receive a performance bonus unless they prove a sale to each of ten different retail customers during each month.”⁶⁶ The judge found Amway’s ten customer rule a sufficient policy towards encouraging retail sales to nonparticipants.
- b. **Seventy Percent Rule**—The *Amway* seventy percent rule required distributors to resell at least seventy percent of the products they purchased each month to bona fide customers.⁶⁷ The rule ensured that distributors did not attempt to secure performance bonuses solely on the basis of personal purchases.⁶⁸

Since *Amway*, most network marketing companies have a form of these safeguards. As evidenced by later opinions, these safeguards are worthless unless they are effectively enforced.⁶⁹ *If a network marketing company lacks effective policies requiring its sales*

force to sell products to nonparticipants, its business form could be abused by distributors and transformed into an endless chain scheme.

In recent years, Amway has been under attack by consumers and regulators across the world. Amway has encountered two class action lawsuits in the United States and regulatory actions in India and the United Kingdom. Pyramid scheme allegations are nothing new to Amway in particular,⁷⁰ and nothing new to the network marketing industry in general.

In January of 2007, a class action lawsuit was filed against Amway alleging Amway to be a pyramid scheme. In Pokorny et al. v. Quixtar, the plaintiffs allege Quixtar (synonymous with Amway) requires constant recruitment to remain afloat.⁷¹ Rather than selling products to nonparticipants, the plaintiffs allege Quixtar distributors focus

primarily on recruiting additional distributors to purchase and consume the Quixtar products. The plaintiffs allege, “In practice, 95% of Quixtar’s products are not sold to retail customers, but rather to [distributors]. Because the [distributors] are Quixtar’s actual customers and consumers of its products, Quixtar requires an ever expanding network of so-called distributors (IBOs) in order to keep Quixtar afloat.”⁷² The case is currently being litigated in the Central District of California.

On August 9, 2007, another class action lawsuit was filed against Amway alleging them to be an illegal pyramid scheme.*¹ The plaintiffs alleged that Amway over time devolved from a legitimate network marketing company into an illegal pyramid scheme

* *DISCLOSURE.* The class action lawsuit referenced here was filed by various Quixtar leaders affiliated with Team, a tool company that supported Quixtar distributors. I served as in-house counsel to Team at the time of the filing and during litigation up to February of 2009. I am now operating my own practice, [The Advocate Group](#).

dependent on constant recruitment and internal consumption.⁷³ The plaintiffs further argued Amway fails to enforce its own rules designed to encourage retail sales.⁷⁴ They alleged,

Because [Amway]’s products are unmarketable, financial gains to [Amway] distributors are primarily dependent upon the continued, successive recruitment of other participants who purchase [Amway] products in order to qualify for commissions. Instead of selling the products to people unrelated to [Amway], distributors personally consumed them or discarded those they did not use. . . This fact alone renders [Amway] a classic recruitment pyramid scheme.⁷⁵

Within sixty days, the lawsuit was summarily dismissed in favor of Amway’s arbitration provision in its contract.⁷⁶ Unlike Pokorny, the Woodward lawsuit was filed by top-level distributors within the Amway hierarchy. Several of the named plaintiffs were members of Amway’s advisory board, also known as the Independent Business Owners Association International board.

In India, Amway is currently under investigation for violating criminal laws in India regarding money circulation schemes.⁷⁷ In an order denying Amway's motion to stop the investigation of its business practices, the court held,

It is, thus, evident that the whole scheme is so ingeniously conceived that *the inducement for aggressive enrollment of new members to earn more and more commission is inherent in the scheme.* By holding out attractive commission on the business turned out by the downline members, the scheme provides for sufficient inducements for its members to chase for the new members in their hot pursuit to make quick/easy money. . . From the whole analysis of the scheme and the way in which it is structured it is quite apparent that once a person gets into this scheme he will find it difficult to come out of the web and it becomes a vicious circle for him.⁷⁸

Amway [appealed the court's decision referenced above.](#)⁷⁹ The final outcome has not been decided.

Amway UK

I've saved the best for last. Amway in the UK. In England, Amway has recently faced one of their toughest challenges. The UK government took aggressive action against Amway for some of its marketing practices. Amway, by the skin of its teeth, survived its close encounter with the UK government. In April of 2007, the Department for Business Enterprise and Regulatory Reform (“DBERR”), counterpart to the FTC in the United States, [presented a petition to wind up Amway](#).⁸⁰ In addition to attempting to wind up Amway, the original petition sought to wind up tool companies responsible for misrepresenting the Amway opportunity.⁸¹ Immediately after the petitions were filed in England, [Amway prohibited the sale](#) and distribution of all support materials produced by tool companies.⁸² As a result of this immediate action, Amway effectively shut down

the tool companies before the government got the chance.⁸³ Additionally, Amway placed a moratorium on all sponsoring, meaning distributors were not allowed to recruit other participants into the business.⁸⁴ The DBERR alleged that Amway was inherently objectionable, operating as an unlawful lottery and operating as an unlawful trading scheme.⁸⁵ Once the proceeding was initiated, Amway made drastic changes to its business in England. Without these changes, Amway likely would have been shut down.⁸⁶

In the final order, the judge made some key observations regarding Amway's business model. When commenting about the lack of actual selling, he observed, "[I]n truth only about 9% of registered [distributor's] are actively involved in retailing."⁸⁷ The Order points out that the vast majority of Amway's product volume was from distributor

purchases, not customer sales. When commenting on the viability of the Amway opportunity in England, the Order states,

What this case has been about is the disparity between the dream that is sold to and the reality of the opportunity that is gained by [distributors].⁸⁸ . . . If one were to represent this bonus distribution on a graph with a central vertical axis containing the commission bands . . . and the horizontal axis calibrating the number of people in the class, *then the bar graph would resemble not a pyramid but a candle stick, with a large solid base of [distributors] who earned nothing or vitually nothing and a thin column of [distributors] arising out of it. . .*⁸⁹

In other words, the Amway opportunity pitched by distributors was realized by very few people.

During the proceeding, Amway had to answer for some of the marketing tactics employed by various distributors via their tool companies. As mentioned earlier,

Amway allows its high level distributors to develop satellite tool companies designed to assist distributors sponsor other distributors and sell Amway products. According to Amway in a press release, the proceeding was initiated by the DBERR “following the receipt of complaints about [tool companies] and misrepresentation of the business to prospective [distributors].”⁹⁰ In [another press release](#), Amway pulled back from its aggressive rhetoric against its sales force and stated, “Amway’s fault, according to the petition, lies in our failure to take sufficient action to prevent these abuses from occurring.”⁹¹ According to the Order, **Amway tried arguing that it cannot be held liable for practices employed by its independent sales force.** The judge took exception to the argument and made the following statement in the Order:

I do not agree.. . . Amway cannot reap the benefit of such misstatements or misrepresentation without accepting the proper consequences flowing from the means by which that benefit was obtained. *It permitted itself to be surrounded with a penumbra of impropriety, and took the advantages to its business thereby gained.*”⁹²

Since Amway benefited from the misrepresentations made by distributors, the judge disallowed them the ability to shift blame. Amway is dealing with similar allegations in the United States, as evidenced by the Pokorney et al class action lawsuit.⁹³ The UK Order is encouraging in a sense. It demonstrates that courts should be hesitant to exonerate network marketing companies by simply glancing at their retail sales rules. Instead, courts should look at the totality of the circumstances and hold the company accountable for practices employed by its sales force.

Tiered Approach: The Cure to Amway's Cancer

Amway barely survived its brush with the UK government. Without the significant changes made by Amway during the proceeding, the judge clearly said he would have shut them down.⁹⁴ In my opinion, Amway's problems were self-imposed because, as noted by the Judge in the UK, it "permitted itself to be surrounded with a penumbra of impropriety."⁹⁵ Immediately after the proceeding was initiated, Amway took drastic measures to get its business in line.⁹⁶ During the process, **Amway discovered a CURE** that will protect its business model and prevent pyramiding from its distributors: a **tiered qualification system**. If implemented across the board in the United States, the tiered approach adopted by Amway in the UK will significantly thwart the proliferation of pyramids. In the Order, the judge illustrates his enthusiasm for the tiered

approach by stating, “Amway has re-designed existing [distributors] as ‘Amway Business Owners’ (ABOs) and devised a tiered qualification system as ‘retail consultant’, ‘certified retail consultant’ and ‘business consultant’.”⁹⁷ In summary form, the tiers are as follows:


- i. Retail Consultant—A retail consultant represents the entry level with the defined role of finding customers for Amway products. “The retail consultant has a *pure sales function and cannot sponsor anyone to become a [distributor]*.**
- ii. Certified Retail Consultant— A retail consultant may become a certified retail consultant provided they have an established customer base of five customers purchasing a combined total of \$400 USD of product a month.”⁹⁸ Consultants must maintain their customer volume and *are authorized to recruit other IBOs*. They can earn commissions from their recruits’ volume, also referred to as “downline volume.”⁹⁹**
- iii. Business Consultant—They must maintain their customer base and achieve a certain level. Once the level is achieved, they take on an enhanced leadership role in motivating and training their downline. They can**

produce training and support material for their downline, so long as the material meets Amway's approval.¹⁰⁰


The tiered approach is significant for multiple reasons. Since the approach requires each distributor to reach a retail sales quota *before* they can sponsor other distributors, it eliminates the possibility for the sales force to focus exhaustively on recruiting additional participants. Instead of relying on opportunity driven demand, the tiered approach forces the network marketing company to offer marketable products appealing for nonparticipants. With a tiered approach, commissions are driven primarily from customer sales, not recruitment based bonuses driven primarily from internal consumption of the sales force. Additionally, the approach ensures that only competent

distributors sponsor others into the organization. In all practicality, distributors should forgo sponsoring additional participants until they have demonstrated the proper skill sets by successfully selling the company's products. When the only people buying products are distributors, the only way for distributors to earn income is to enroll more distributors to do the same. Opportunities driven by constant recruitment are untenable business models.

Another benefit to the tiered approach is that it will naturally curb geographic market saturation. In the FTC action against Amway in the 1970s, the initial complaint alleged Amway to be a pyramid because they focused on recruitment which rendered it virtually impossible for later participants to recruit others due to market saturation.¹⁰¹ With a tiered approach, distributors are required to accrue customers before sponsoring other distributors. The process avoids the problem of having thousands of distributors in a particular region, each trying to recruit from the same pool in a rapidly diminishing market of prospects. Network marketing companies need to refrain from devolving into “buyers



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clubs” where distributors “buy from their own business” and, out of necessity, recruit others to do the same. It’s companies like that that lead to the culture of overstatement and give people a negative impression of this industry. Instead, the industry needs to be perceived as any other product-based business driven by a sales force. Pharmaceutical companies would never position thousands of sales reps in the same region to service a particular market. Policies need to be implemented and enforced to encourage retail sales and protect distributors from market cannibalization.

There is a flip-side to the market saturation argument. In King and Robinson’s book, the authors argue market saturation is unlikely since distributor penetration is relatively low compared to the total U.S. population.¹⁰² Accordingly, since there is a vast expanse of potential recruits, there are plenty of opportunities for distributors to find

other individuals that will purchase products and recruit without tapping out the market.

Understandably, there are competing views on this issue.

Time for legislation?

In FTC v. Burnlounge, the FTC's most recent case against a network marketing company, FTC senior economist Peter Vander Nat executed an affidavit and articulated the evils of endless chain schemes. He states, "As recruitment continues, the number of people who are at or near the base of the recruitment structure grows very rapidly, often at an exponential rate for as long as a successful recruitment pattern is maintained." He

further states, "**[I]n a pyramid scheme, the number of people who lose money increases exponentially for as long as a**

successful recruitment pattern is maintained.”¹⁰³ It would greatly help consumers AND the good-folks of the industry if there was clearly-written legislation to prevent companies from exploiting consumers with recruitment-based opportunities. Across the country, consumers are enticed with income and lifestyle representations. Some are legit and some are not. It’s permissible to use income representations when these statements are achieved by selling. The representations are not permissible when consumers are primarily encouraged to become distributors, purchase the company’s unmarketable products on a monthly basis and initiate the recruitment process. In such instances, the opportunity diminishes with each successive generation of recruits while the people at the base of the pyramid, which comprises the vast majority of participants, are harmed when the music stops and the structure collapses.¹⁰⁴ If the products sold have no legitimate market value to nonparticipants,

which can be determined by looking at the percentage of revenue attributable to sales to nonparticipants, the products might be mere tokens disguising an endless chain scheme.

The lesson will continue until the lesson is learned

It appears Amway might have learned from its past shortcomings. In addition to implementing the tiered approach in England, they're [implementing tighter restrictions](#) on their sales force both domestically and abroad.¹⁰⁵ Domestically, they have implemented an accreditation program requiring the third party tool companies to meet minimum standards. Since the marketing tactics employed by its distributors are imputed to them,¹⁰⁶ Amway is instituting tougher policies to control the flow of representations made by its sales force. In my opinion, it was a good second step. The next appropriate step would be to equip and incentivize its massive sales force to sell

products to nonparticipants. Its recent marketing campaign suggests that they intend to move in this direction.

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The class action lawsuits and the enforcement action in England imply, or at least suggest, that Amway purposely failed to enforce its rules. Instead of relying on customer sales, it was alleged in the lawsuits that Amway allowed its field of distributors to promote recruitment as the primary driver of the opportunity. As often happens in the network marketing industry, when the sales force is permitted to operate with a skewed view of the business, it is near-impossible fix. Amway is not alone. They're one of the most

prominent leaders in the industry and their practices are supported by the DSA. In its

revised proposed business opportunity rule, the FTC stated, “[T]he potential collusion between MLM companies and distributors to fake the true level of retail sales would undermine the utility [of the proposed rule].”¹⁰⁷ As evidenced by the FTC’s statement, there’s nothing new when a network marketing company purportedly encourages retail sales on the one hand while allowing its sales force to ignore selling on the other. Not surprisingly, in an effort to create positive sentiments of their brand offerings, Amway has launched a substantial media campaign including commercials, print media and [celebrity endorsements](#).¹⁰⁸ It’s a necessary step to create interest in its products and help its sales force sell.

V. PARABLE OF PETER PONZI AND THE AMAZING PENCIL

Imagine there's an individual by the name of Peter Ponzi. Peter shares no lineage with the infamous Charles Ponzi, who started the world's first "Ponzi scheme," but the two have a lot in common. As with Charles, Peter is an aggressive thinker and always looking for a way to turn a profit. And like Charles, Peter likes to solicit funds from investors with the promise of increasing their money. Peter develops a scheme in which he recruits three participants to give him \$10,000 apiece. In exchange for their investments, Peter sells each participant a license to recruit other investors. When each investor is able to recruit three more participants, Peter doubles their investment by paying them \$20,000. It's a no brainer! As word travels about the fantastic investment opportunity, investors threw their money at Peter's licensed sales reps and rapidly start

looking for more people to do the same. Peter soon realized that limiting each licensed representative to three recruits was hurting his bottom line. He figures he could make exponentially more money if he allows his reps to recruit as many people as possible. Under the banner of free market economics, Peter lets his reps loose!

He eventually senses investors struggling in his home town. Understanding the difficulty of finding recruits with each successive generation, he encourages his investors to seek new recruits in other towns. When growth slowed down a bit, Peter hired an expensive marketing firm and coined the phrase “Feed the Machine—Invest for Success.” He started hosting “investment parties” where people could learn about the wonderful opportunity of transferring wealth from new recruits to earlier investors. Since the term “investment party” carried negative connotations, he started calling the meetings “social gatherings.” Everyone was invited! One day, while talking on his

diamond encrusted iPhone, he spoke with his lawyer, Larry. Larry warned him of the inherent risks of endless chain schemes and said the federal government has been known



Since few people outside the program would purchase the African pencils, the recruits had to focus on recruiting additional participants to buy the pencils for their personal use.



to shut down companies operating as money transfer schemes where no products were sold.

In light of this information, Peter got a brilliant idea. He thinks to himself, “If the government will only allow me to pay commissions on product sales, then I’ll sell a product! I’ll sell \$10,000 pencils!” And sell them he did. But these were not your ordinary pencils. These were pencils cut from the finest African wood. The pencils also had authentic lead that could leave marks on paper while upside down! Excited

by the chance of earning loads of money, prospects joined the program in droves and

bought their pencils. Since few people outside the program would purchase the African pencils, the recruits had to focus on recruiting additional participants to buy the pencils for their personal use. Since prospects are always interested in making extra cash, the program worked...for a while.

Rachel, one his representatives, went to Peter and said, “Pete, I can’t sell these pencils at neither the retail price nor the distributor price. I do the product demos, I write on the paper upside down, but no customers are willing to pay \$10,000 for these pencils.” Peter responds, “You’re not in the pencil business, silly, you’re in the business of making people money! Sell the money, not the pencils!” Rachel heeded his advice and within six months, bought a house on Lake Tahoe.

Larry eventually advised Peter of the need to accrue sales to nonparticipants. Larry said the pencil sales would probably be considered token products that disguise the endless chain scheme. Peter said, “I know just the trick. When my people order the pencil from our website, we’ll just let them check a box on the screen affirming that the pencil will be sold to a customer. If they use the pencil themselves, who cares? And if they don’t make their “customer sales quota,” we’ll hold their bonus. We’re covered, right?” Larry just shook his head in disbelief, took a sip of his coffee, and sighed in disbelief.


Unfortunately, as Larry warned, no program can recruit new participants forever. Peter tried to argue that his records show massive customer sales because everyone was checking their box. The regulators said, “We’re like the IRS...we’re slow but not stupid. The rule must actually lead to customer sales. Peter, you know that no one outside the program buys your stuff. We’ve got hundreds of affidavits from people in

your business stating they were taught to check the box without making sales. Do you prefer top or bottom bunks?”


Peter and friends eventually went to prison for knowingly operating an illegal pyramid scheme. Much to his surprise, the regulators did not see the value of his African pencils and only saw an endless chain scheme where money was transferred from the base of the pyramid to earlier investors. The pencils were seen as mere tokens of the illegal scheme. Distributors purchased the pencils with the intent of earning income by recruiting additional participants. The regulators did not consider the distributors “end users” for purposes of Koscot.

Moral of the story

If the rationale behind HR 1220 prevails, which is the DSA's proposed congressional bill, there would be nothing to stop a company from selling \$10,000 pencils. In Peter Ponzi's business, the participants bought pencils for "personal use." Under HR 1220, commissions based on purchases by distributors for personal use are acceptable. The only thing protecting consumers is the proposed twelve month return policy. The rationale behind a liberal return policy is to give distributors a chance to return any unused inventory upon quitting, thus



***If distributors
consume products
on a monthly basis
with the hopes of
recruiting additional
participants, there is
nothing to return
when he or she
decides to cut their
losses and exit the
scheme.***



preventing them from getting stuck with products they cannot sell. However, what happens when distributors' commissions are calculated on a monthly basis? And what happened when the company's products are consumable i.e. special vitamins, household cleaners or exotic potions? There's nothing to return when the light bulb goes off.

There's only one way to determine if the products are mere tokens for an illegal recruitment scheme: sales to nonparticipants. Nonparticipants are the appropriate metric because they do not act "under the influence" of an income opportunity. They're not trying to make money by purchasing products and recruiting other participants. If customers outside the

distributor network purchase products, the products have legitimate market value. On the contrary, when profits from retail sales are untenable, distributors will focus on recruiting. Lavish income representations are made to entice potential recruits into the



When the rewards presented are available only by recruiting a substantial downline, the business could be operating as an endless chain scheme. Business models like this are illegal.



endless chain scheme. Business models like this are illegal and harmful to consumers both financially and socially.

program. Most of the time, these representations are truthful and accurate. Responsible network marketing companies require their distributors to issue income disclosure statements whenever income is discussed. However, despite the requirement to produce income disclosure forms, when the rewards presented are available only by recruiting a substantial downline, the business could be operating as an

VI. PROPOSED LEGISLATION IN THE STATES

If you want something done right, you need to do it yourself. Since the federal government is slow to act in creating uniform standards in the industry, it is largely up to the individual states to create legislation tailored to protecting citizens from consumer fraud. Fortunately, simple measures can be implemented to effectively curb these abuses. First, a separate act must be passed specifically addressing pyramid schemes. Second, the definition of “customer” must be clearly defined to eliminate all doubt that distributor purchases do not constitute “sales to end users.” Third, the statute must specify the minimum quota of customer sales to remain in business. Fourth, the Attorney General’s office needs to be granted the powers to investigate and prosecute pyramid schemes.

In Tennessee, for example, the pyramid statute is almost forty years old.

State Attorney Generals are responsible for policing consumer fraud in their respective states. While the Federal Trade Commission polices consumer fraud on a national level, the attorney generals have the same authority on a more local level. In August of 2008, the Attorney Generals in the states of California and Florida initiated aggressive actions against two network marketing companies. In both lawsuits, it was alleged that the product sales were merely tokens masking the illegal nature of the endless chain schemes.¹⁰⁸ Although many large network marketing companies gross over a billion dollars in annual revenue, the power of the individual states should never be underestimated. Just ask the tobacco companies.

The Office of the Attorney General in your particular state needs to be effectively equipped with proper legislation to help them facilitate their mandate of protecting

consumers in the state. In most states, like Tennessee, the anti-pyramid legislation has more holes than Swiss cheese. In these cases, enforcement proceeding could easily cost



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several million dollars in litigation expenses, which would be a strain for any state government.

The State of Wyoming offers a good example of the structure of anti-pyramid legislation. First, there is a separate statute created specifically for “Multilevel and Pyramid Distributorships.”¹⁰⁹ Instead of a one-size-fits-all approach, it’s important to have a statute narrowly tailored for pyramid schemes. The statute clearly defines key terms and specifically grants the attorney general investigatory and

injunctive powers over violators of the act.¹¹⁰ In your state, the statute needs to specifically prohibit programs wherein the financial gains are *primarily dependent* upon continued recruitment of other participants. The compensation plans must be driven primarily from sales to nonparticipants. The term “nonparticipant” needs to be clearly defined as an individual unaffiliated with the network marketing opportunity, which means the “nonparticipant” must not be part of the organization’s hierarchy.

While contemplating the definition of “customer” or nonparticipant, the statute must specify the minimum amount of sales to nonparticipants. Since the FTC has required various compensation plans to be driven primarily by customer sales, the word “primarily” would indicate that a fifty-one percent minimum is appropriate. If the network marketing company instituted an equivalent to Amway’s old ten customer rule requiring its distributors to sell products to nonparticipants as a condition precedent to

receiving bonuses, the customer sales will significantly outweigh distributor purchases. Since customers have no profit motive when they make purchases, they are the ultimate metric when measuring the marketability of the products. When there's legitimate demand for the product, distributors are protected.

In order to avoid companies manipulating their customer sales, which is a problem according to the FTC,¹¹¹ the statute needs to require network marketing companies to effectively enforce their retail sales policies. It can be done by requiring companies to request receipts of customer sales made by distributors. With some of the larger network marketing companies with hundreds of thousands of distributors, this could be a difficult task. It could also be done by standardizing Amway's tiered approach used in England, or by standardizing Amway's ten customer rule. If distributors were required to demonstrate a proficiency in selling before recruiting, it would effectively curtail all

recruitment based pyramid schemes. Moreover, with the tiered approach, customer sales would dramatically outweigh volume generated by distributor consumption.

VII. CONCLUSION

The transgressions of a few should not spoil the reader's perception of the entire industry. There are some fantastic network marketing companies in the United States. They're the ones shouting about the efficacy of their product lines. They're the ones with appropriate compensation plans designed to incentivize retail sales. They're the ones with competent compliance departments towing the line and enforcing their sales policies. They're the ones that attribute a large portion of their sales to nonparticipants. They're the ones that tout success in terms of customer sales, not distributor acquisition. The industry is not going to be regulated away. On the contrary, I imagine with

technological advancements, there will be greater demand for unique products offered exclusively via network marketing channels. The network marketing industry is the perfect model for introducing innovative and unique products into the marketplace. With the right compensation plan, distributors are positioned earn their income by communicating the benefits of unique products. Unfortunately, there are companies that rely on their compensation plans and sales leaders to cast a trance on distributors to purchase products they otherwise would never purchase at prices they would never pay. Opportunity driven demand leads to significant economic harm at the expense of average consumers seeking viable opportunities. A wise man once said “Money can’t buy happiness, but it sure can rent it!”

We’re all influenced by the want of money and with the current economic recession, there are scores of people starving for viable opportunities. If done properly, companies

in the network marketing industry can meet this increased demand and tee the industry up for an explosive decade. However, if the current problems are allowed to persist, the rest of the industry will be hamstrung by the consequences of endless chain schemes.

“What can I do?”

Congratulations! If you’ve made it this far in the article, it means you’re now one of the most informed consumers in the country regarding endless chain schemes. So now what? Legislators need to be educated on the issues and hear your story before they can be expected to do anything. Here’s how you get started:

First, forward these articles to your friends and relatives. The best defense against consumer fraud is an informed group of consumers.

Second, send this article to the state legislator in your particular district. It's our civic duty to educate our legislators when we learn of issues that affect our communities. Simply Google "state legislators of INSERT STATE" and let your fingers find their contact information. Tell them a little bit about yourself like where you're from, why this issue is important to you, and why it's important for the citizens in your community.

And lastly, [click here](#) to find the attorney general's email address in your state. If an email address is not listed, it means it wasn't included on their website. At a minimum, email them the link to this article and tell them it's something they should study.

If you want to talk about some specifics in this article, please feel free to drop me a line at: kevin [at] theadvocategroup [dot] net.

About the Author

Kevin is a lawyer, entrepreneur, and agent of change. He's the founder and president of [The Advocate Group](#) that specializes in transactional work and start-up formation for network marketing companies. Kevin provides entrepreneurs with the tools necessary to get their businesses successfully off the ground on secure legal footing.



Prior to starting The Advocate Group, Kevin gained valuable experience while serving as Chief Counsel for Signature Management Team, LLC, also known as Team. Team is one of the largest providers of sales aids for distributors in the network marketing industry. While at Team, Kevin worked closely with Amway and Mona Vie's compliance departments to ensure Team's marketing materials passed regulatory review. Also during his tenure at Team, Kevin helped guide the company through commercial litigation with Amway. He's recently published a widely read, 80 page ebook on the changing state of the law in the network marketing industry. Read [the ebook here](#), free of charge, to learn more about the laws in the industry.

For more information, please contact Kevin directly at: Kevin [at] theadvocategroup [dot] net. You can read Kevin's commentary on his blog, [Next Generation Law](#).

ENDNOTES

¹ Charles King & James Robinson, *The New Professionals: The Rise of Network Marketing As the Next Major Profession* 72 (2000).

² *Id.*

³ *Id.* at 73.

⁴ *Id.* (quoting Biggart, Ph.D., Nicole Woolsey, *Charismatic Capitalism*, The University of Chicago Press, 1989).

⁵ King, *supra* note 1, at 182.

⁶ Adatudes, *Transformation Station: Logo Preview*,

<http://adatudes.opportunityzone.com/2008/01/14/Transformation-Station-Logo-Preview.aspx>

(January 14, 2008).

⁷ Johnson, et al. v. Usana Health Sciences, Inc., No. 37-2007-00053808 (San Diego County filed June 20, 2007); Woodward, et al. v. Quixtar, Inc. No. 07-5194 GAF (C.D. Cal. filed August 9, 2007); Pokorny, et al. v. Quixtar, Inc., No. C 07-0201, ¶ 60 (N.D. Cal. filed January 10, 2007); Morrison, et al. v. YTB.com, et al., No. 08-cv-565-GPM (S.D. Ill. Filed August 8, 2008).

⁸ In California, the state Attorney General’s office recently filed an action against publicly traded “Your Travel Biz.” In the complaint, the State of California alleges, “Only 14.5% of Defendants’ net revenue was generated from the sale of travel. In short, Defendants sell an illegal pyramid scheme that uses the minor, incidental sale of travel as a front for their scheme.” People of the State of California v. YTB.com, et al, ¶ 4, *available at* http://ag.ca.gov/cms_attachments/press/pdfs/n1596_civil_pleading_ytb.pdf#xml=http://search.doj.ca.gov:8004/AGSearch/isysquery/5be5b0ae-f6f4-4398-a76b-0efb923d7849/1/hilite/

Additionally, in Florida, the state Attorney General’s office recently filed an action against another network marketing company called “Ad Surf Daily.” The state alleges that the Ad Surf commissions are “not primarily contingent on the volume or quantity of goods, services or other property sold in bona fide sales to consumers and which is related to the inducement of additional persons to participate in the same sales or marketing plan or operation.” *State of Florida v. Adsurfdaily, Inc., et al*, ¶ 32, *available at* [http://myfloridalegal.com/webfiles.nsf/WF/KGRG-7H9MY7/\\$file/ASDComplaint.pdf](http://myfloridalegal.com/webfiles.nsf/WF/KGRG-7H9MY7/$file/ASDComplaint.pdf) (emphasis added).

⁹ Woodward, et al. v. Quixtar, Inc. No. 07-5194 GAF (C.D. Cal. filed August 9, 2007).

¹⁰ *Id.* at ¶ 43.

¹¹ Press Release, Quixtar Newsroom, *Quixtar Reports Fourth Consecutive Year Of Billion-Dollar Sales*,

http://www.quixtarnewsroom.com/pr/quixtar/2006_annual_sales.aspx (February 2, 2007).

¹² Quixtar Blog: Information, Perception , Discussion, *Platinum Index*,

<http://www.webraw.com/quixtar/resources/files/platinumindex.gif> (2004). This statistic does not factor in physical, person to person sales made by distributors.

¹³ Amway argues its distributors should be considered customers. The DSA supports this position. Due to the uncertainty in the industry over the definition of “ultimate user,” there’s room for this argument.

¹⁴ King, *supra* note 1, at 113.

¹⁵ *Id.*

¹⁶ In 2006, Dateline did a story about the charismatic messages espoused by various Quixtar distributors.

¹⁷ *Whole Living, Inc. v. Tolman*, 344 F.Supp.2d 739, 744 (D. Utah 2004) (*quoting In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106 (1975)).

¹⁸ Federal Register, Revised Proposed Business Opportunity Rule, 16 C.F.R. 437, p. 36 (proposed March 18, 2008), *available at* <http://www.ftc.gov/os/2008/03/R511993business.pdf>.

¹⁹ *Id.* (emphasis added).

²⁰ *Id.* at 50.

²¹ *In re Koscot Interplanetary, Inc.*, 1975 FTC LEXIS 24, at *166-67 (Nov. 18, 1975) (emphasis added).

²² *SEC v. International Loan Network, Inc.*, 968 F.2d 1304, 1309 (D.C. Cir. 1992).

²³ *Webster v. Omnitrition International, Inc.*, 79 F.3d 776, 781 (1996).

²⁴ *See* Revised Proposed Business Opportunity Rule, *supra* note 16, at 26. In this section of the proposed rule, the Federal Trade Commission states, “For example, some industry commenters

argued that only the earnings of so-called “active” distributors should be considered because many individuals use their distributorship as a “buyers club” and are only interested in purchasing goods at a wholesale price for their own use, not for resale.”

²⁵Direct Selling Association, *Federal Legislation Will Differentiate Legitimate Multilevel Marketing Businesses from Illegal Pyramid Schemes*,

http://www.dsa.org/Press/press_releases/index.cfm?fuseaction=show_release&Document_id=393 (April 14, 2003).

²⁶ Debra Valentine, General Counsel for the U.S. Federal Trade Commission, Speech at the Seminar on Current Legal Issues Affecting Central Banks, (May 13, 1998), *available at* <http://www.ftc.gov/speeches/other/dvimf16.shtm>.

²⁷ *Id.* In her speech, Debra Valentine said, “Some schemes may purport to sell a product, but they often simply use the product to hide their pyramid structure. . . . [P]yramid and Ponzi

schemes are illegal because they inevitably must fall apart. *No program can recruit new members forever.*”

²⁸ Revised Proposed Business Opportunity Rule, *supra* note 16, at 43.

²⁹ Koscot, *supra* note 20.

³⁰ *Id* at *68.

³¹ *Id.* at 13. (emphasis added).

³² Peter Vander Nat & William Keep, *Marketing Fraud: An Approach for Differentiating Multilevel Marketing from Pyramid Schemes*, in *Journal of Public Policy & Marketing*, Spring 2002, at 144. (emphasis added).

³³ Omnitrition, *supra* note 22.

³⁴ *Id.* at 782.

³⁵ *Id.*

³⁶ *Id.* at 783 (emphasis added).

³⁷ *Id.* (emphasis added).

³⁸ Koscot, *supra* note 20, at *13.

³⁹ *See* Federal Trade Commission v. Burnlounge, Inc., et al, No. 2:07-cv-03654 (C.D. Cal. 2007); Federal Trade Commission v. Trek Alliance, Inc., et al, No. CV-02-9270 DSF (C.D. Cal. 2005); Federal Trade Commission v. Equinox, No. CV-S-99-0969-JBR (D. Nev. 1999); Federal Trade Commission v. Futurenet, Inc., No. cv-98-1113 GHK (CD. Cal. 1998); Federal Trade Commission v. World Class Network, et al, No. SACV-97-162 AHS (C.D. Cal. 1997); Federal Trade Commission v. JewelWay, et al, No. CV-97-383 TUC (D. Ariz. 1997); Federal Trade Commission v. Fortunate Alliance, No. C96-799M (W.D. Wash. 1997).

⁴⁰ Stipulated Final Order for Permanent Injunction at 4, Federal Trade Commission v. Trek Alliance, Inc., et al, No. CV-02-9270 DSF (C.D. Cal. 2005).

⁴¹ In Federal Trade Commission v. World Class Network, Federal Trade Commission v. Five Star Auto and Federal Trade Commission v. Jewelway et al similar definitions were applied. In JewelWay, the Order prohibited the defendant from selling an opportunity that relies on recruiting “rather than by the sale of goods or services to persons not eligible to recruit representatives into the marketing program, [also known as nonparticipants].” Stipulated Final Judgment and Order for Permanent Injunction at 2, Federal Trade Commission v. JewelWay, et al, No. CV-97-383 TUC (D. Ariz. 1997). In World Class Network, the Order states that the Defendant’s compensation plan must be driven primarily from sales to nonparticipants. Stipulated Final Judgment and Order for Permanent Injunction at 2, Federal Trade Commission v. World Class Network, et al, No. SACV-97-162 AHS (C.D. Cal. 1997)

⁴² Staff Advisory Opinion—Pyramid Scheme Analysis, Op. F.T.C. (2004).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ Press Release, Direct Selling Association, *Federal Legislation Will Differentiate Legitimate Multilevel Marketing Businesses from Illegal Pyramid Schemes*,

http://www.dsa.org/Press/press_releases/index.cfm?fuseaction=show_release&Document_id=3

93 (April 14, 2003).

⁴⁶ Utah Criminal Code, §76-6a-2 (2008).

⁴⁷ *Id.* (emphasis added).

⁴⁸ DSA Press Release, *supra* note 44.

⁴⁹ H.R. 1220, 108th Cong. (2003).

⁵⁰ *Id.*

⁵¹ DSA Press Release, *supra* note 44.

⁵² Order of Dismissal, *Woodward v. Quixtar, Inc., et al*, No. 07-5194 GAF (C.D. Cal. 2007) (holding that the plaintiffs must submit to Quixtar’s dispute resolution procedures).

⁵³ Federal Register, Revised Proposed Business Opportunity Rule, 16 CFR 437, page 21 (2006) (stating “These commenters pointed out that the fees top MLM companies charge prospective distributors for the right to sell products are low—often less than \$100.” *Id.*

⁵⁴ *Id.* at 38.

⁵⁵ Direct Selling 411, *Don’t We all Have the Same Goal?*,

<http://www.directselling411.com/tag/dsa-critics/> (stating that the DSA operates to keep direct selling businesses in business).

⁵⁶ King, *supra* note 1, at 121.

⁵⁷ *Id.*

⁵⁸ Amway Rules of Conduct at 4.22, *available at*

<http://www.quixtar.com/Business/default.aspx?cid=4175&pid=573>

⁵⁹ In Woodward et al v. Quixtar, the plaintiffs alleged that Amway does not enforce its retail sales rule by allowing its distributors to “self report” customer sales when no customer sales were made. Woodward, *supra* note 8 at at ¶ 94. The same allegation was made in Pokorny v. Quixtar. In Pokorny, the plaintiffs alleged, “[Amway] does not even enforce the [retail sales rule] as written. In order to appear to enforce this rule, [Amway] created a ‘self-reporting’ system for distributors to certify that they comply with this policy. Quixtar knows that this rule is not followed and that the [high-level distributors] uniformly instruct the downline distributors to “check” the [retail sales] box on their reporting form, regardless of whether they have made sales to retail customers.” Pokorny, et al. v. Quixtar, Inc., No. C 07-0201, ¶ 60 (N.D. Cal. filed January 10, 2007).

⁶⁰ See *See Revised Proposed Business Opportunity Rule*, *supra* note 16, at 48 (emphasis added).

⁶¹ *Omnitrition*, 79 F.3d at 783 (emphasis added).

⁶² In *Whole Living, Inc. v. Tolman*, the direct selling company survived the pyramid allegations largely in part due to their effective enforcement of their rules. *Whole Living, Inc. v. Tolman*, 344 F.Supp.2d 739 (D. Utah 2004). In *Whole Living*, the judge appreciated the fact that customers purchased products directly from the company, not via distributors. With direct selling, customers often have the ability to place orders directly with the company. Upon checkout, the customer is required to provide their distributor's referral number to ensure the sale gets credited to the right person. In an effort to eliminate the possibility of "collusion" between a direct selling company and its distributors, legislation could be passed requiring companies to pay out commissions only after the distributor has garnered a minimum number

of customer sales via the company portal. If the company processes all the orders for the customers, there will be no need to require the field to manually “certify” their customer sales. On the other hand, one of the functions of distributors in the direct selling industry is to personally explain the benefits of the various products. With such a rule, the person-to-person contact would be undermined. Clearly, it’s a very difficult policy to police, but it’s also very important to get the right behavior.

⁶³ King, *supra* note 1, at 183.

⁶⁴ *In re Amway Corp.*, 93 F.T.C. 618 (1979).

⁶⁵ King, *supra* note 1, at 91.

⁶⁶ *Amway*, 93 F.T.C. at 26.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ See *Omnitrition*, 79 F.3d at 784 (holding “Omnitrition’s *Amway* defense must fail . . .

because “the crucial evidence the actual *effectiveness* of its anti-pyramiding distribution rule is missing.”)

⁷⁰ In a lawsuit filed by Amway against Proctor and Gamble, Amway alleged P&G was tortiously interfering with their business by defaming them. The court held, “The question of Amway's being an illegal pyramid has been in the public forum for years . . .” *Amway Corp. v. P&G*, 2001 U.S. Dist. LEXIS 14455 (D. Mich. 2001).

⁷¹ Pokorny, No. C 07-0201 at ¶ 35.

⁷² *Id.*

⁷³ Woodward, *supra* note 8.

⁷⁴ In Woodward, the plaintiffs alleged, “[Amway] does not enforce the F.T.C.’s ten customer rule or its own retail sales rule.” Woodward, *supra* note 8 at ¶ 94.

⁷⁵ Woodward, *supra* note 8 at ¶ 31, 71.

⁷⁶ Order of Dismissal, Woodward v. Quixtar, Inc., et al, No. 07-5194 GAF (C.D. Cal. 2007).

⁷⁷ India PR Wire, *Apex court clears deck for probe into Amway's direct sale scheme*,
<http://www.indiaprwire.com/businessnews/20070814/23903.htm> (August 14, 2007).

⁷⁸ Order, Union of India v. Amway India Enterprises, Writ Petition Nos. 20470 and 20471 at p.
10 (2006) *available at* http://hc.ap.nic.in/orders/wp_20470_2006.html (emphasis added).

⁷⁹ Press Release on Amway Media Blog, *India: rites of passage*,
<http://amwaynews.alticorblogs.com/2007/08/01/india-rites-of-passage/> (August 1, 2007).

⁸⁰ Order, The Secretary of State for Business Enterprise and Regulatory Reform v. Amway
(UK) Limited, Nos. 2651, 2652 and 2653 at ¶ 6 (2007) *available at*
http://www.amquix.info/pdfs/UK/UK_Amway_Judgment.pdf.

⁸¹ *Id.*

⁸² Press Release on Amway Media Blog, *OK, let's talk UK*,

<http://amwaynews.alticorblogs.com/2007/05/07/ok-lets-talk-uk/> (May 7, 2007).

⁸³ The Judge stated, “Petitions were also presented against [two tool companies] but these have been the subject of arrangements made between the presentation of the petitions and the hearing of the Amway petition and so are not before me.” *Amway UK*, *supra* note 79 at ¶ 6.

⁸⁴ Press Release, *supra* note 81.

⁸⁵ *Amway UK*, *supra* note 79 at ¶ 6.

⁸⁶ *Id.* at ¶ 48.

⁸⁷ *Id.* at ¶ 37. The product prices could have been a factor behind the small sales figure. The judge commented briefly about the prices of Amway products. The judge state, “There is some evidence to suggest that Amway goods were overpriced (and indeed Amway made very

substantial across-the-board cuts after the commencement of the investigation...). But this case has not been about product pricing, and I make no findings.” *Id.*

⁸⁸ *Id.* ¶ 53.

⁸⁹ *Id.* ¶ 42 (emphasis added).

⁹⁰ Press Release, *supra* note 81.

⁹¹ Press Release on Amway Media Blog, *You asked for it*,

<http://amwaynews.alticorblogs.com/2007/05/24/you-asked-for-it/> (May 24, 2007).

⁹² Amway UK, *supra* note 79 at ¶ 54(1) (emphasis added).

⁹³ Pokorny et al v. Quixtar, Inc., No. C 07-0201, ¶ 33 (N.D. Cal. filed January 10, 2007).

⁹⁴ *Id.* at ¶ 48 (The judge held, “On the facts as I have so far found them ***I would have considered it just and equitable to wind Amway up.*** I would have done so on a narrow ground which it is necessary to identify.”)

⁹⁵ *Id.* at ¶ 54(1).

⁹⁶ Press Release, *supra* note 81.

⁹⁷ Amway UK, *supra* note 79 at ¶ 57(b).

⁹⁸ *Id.* (emphasis added).

⁹⁹ *Id.* (emphasis added).

¹⁰⁰ *Id.*

¹⁰¹ *In re Amway*, *supra* note 62 at 716.

¹⁰² King, *supra* note 1, at 119.

¹⁰³ Affidavit of Peter Vander Nat at ¶ 4, *Federal Trade Commission v. Burnlounge*, No. 2:07-cv-03654-GW (C.D. Cal. 2007).

¹⁰⁴ *Id.*

¹⁰⁵ Quixtar Professional Development Accreditation Program, *available at*

<http://www.quixtaraccreditation.com/>.

¹⁰⁶ In the Matter of Southwest Sunsites, the defendant argued that it should not be held liable for the acts of its independent contractors. In response to this argument, the court held, “Respondents also may violate Section 5 when actions of agents vested with apparent authority deceive the public for the benefit of the respondent. . . . Indeed, even where a principal has made efforts to prevent misrepresentations or to limit actions by agents the principal may be held liable under Section 5 if the agents, acting within the scope of their apparent authority as

manifested to the consumer, ignored the principal's directives and violated the law. In the Matter of Southwest Sunsites, Inc., 105 F.T.C. 7, 349 (1980).

¹⁰⁷ Revised Proposed Business Opportunity Rule, *supra* note 16, at 48.

¹⁰⁸ Inside Quixtar, *Not what you expected*,

<http://insidequixtar.opportunityzone.com/2008/07/14/Not-what-you-expected.aspx> (July 14, 2008).

¹⁰⁹ YTB, *supra* note 7, at ¶ 4; Adsurfdaily, *supra* note 7, at ¶ 32.

¹¹⁰ Wyo. Stat. § 40-3-101 (2008).

¹¹¹ *Id.* at § 40-3-102, 111, 114 (2008).

¹¹² Revised Proposed Business Opportunity Rule, *supra* note 16, at 48.