THE CHAOS OF MULTILEVEL MARKETING AND PYRAMID SALES LAWS: A FEDERAL REMEDY

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In August of 1990, the Miami office of The State of Florida Attorney General determined that Corporate Suites' Ultimate Money Machine, headquartered in Fort Lauderdale, Florida, was an illegal pyramid scheme.[1] Company officials claimed the program was a legal multilevel marketing plan in which individuals who pay $300 for a "motivational" tape package are given the opportunity to recruit others who, in turn, pay $300 to buy the tapes and join the program. Commissions can be earned on tape sales going four levels deep.[2] Corporate Suites did not dispute the charges but relocated to Georgetown, Grand Cayman Island to avoid Florida prosecution.[3] In an effort to overcome Florida's lack of jurisdiction over Corporate Suites, the U.S. Postal Service in November 1990 obtained a temporary restraining order in a federal district court that stopped the scheme from being promoted through the mail.[4] By this time, however, thousands of dollars were lost by participants in what Richard Scott of the Miami Attorney General's office calls "one of the most blatant pyramid schemes in recent memory."[5]

[1] Network Newswatch Newsletter, December 1990, Volume I - Number 1 p. 5.

[2] Network Newswatch Newsletter, February 1991, Volume - Number 3, p. 4. For explanation of how multilevel marketing "levels" operate see notes 39-41 and accompanying text.

[3] Network Newswatch, supra note 1.

[4] Id.

[5] Telephone interview with Richard Scott, Attorney with the Florida Attorney Generals Office (February 14, 1991).

At about the same time that Corporate Suites began its illegal enterprise, 28-year old Julie Marcinek of Massachusetts became involved with a multilevel marketing company called Nu Skin International.[6] Specializing in the personal care industry, Nu Skin's sales soared from $200,000 in 1984 to over $300 million in 1990.[7] Nu Skin products are sold throughout the United States exclusively by a network of over 100,000 independent distributors. The sales force meets directly with customers in their homes and offices to demonstrate and sell Nu Skin products. Their income is the difference between the retail price at which the distributor sells the product and the price at which the distributor purchases the product from the company (wholesale price). Distributors can also devote considerable time to enlist new distributors for more financial rewards. The distributor can receive between 5% and 14% of the wholesale purchases of those they recruit to be distributors.

According to Marcinek, Nu Skin has changed her life: "Twelve months ago, I was close to personal bankruptcy. I had no money to my name, no credit card, no car."[8] After twelve months of

[6] Paul Keegan, Dreams and Schemes, Boston Business, October, 1990, at 34.

[7] Personal interview with Blake Roney, Founder of Nu Skin and Steve Lund, General Counsel for Nu Skin, (February 21, 1991). The estimate for Nu Skin's 1990 sales would not be confirmed or denied by Roney or Lund. Top Nu Skin personnel and distributors, however, confirmed the estimate.

[8] Supra note 6, at 34.

involvement with Nu Skin, Marcinek is earning close to $7,000 a month.[9] Other individuals have had even more rapid success with Nu Skin. Dr. Hung Tai Wong, a former research chemist with the federal government, was earning over $45,000 a month after only 17 months of involvement.[10] As of March 1991, Nu Skin has not been found to be an illegal pyramid by any regulatory body.[11] Nu Skin was, however, almost charged with violating the Florida Pyramid Statute by the Miami office of the Florida Attorney General before "the main office decided that Nu Skin was not a pyramid. "[12]

In probably the most widely publicized pyramid scheme in history, FundAmerica founder Robert T. Edwards was arrested on July 19, 1990 by Florida authorities on charges of operating an illegal pyramid scheme.[13] In less than four years after FundAmerica first began, nearly 100,000 individuals in eight states bought into the plan, and in the first four months of 1990,

[9] Id.

[10] Interview with Dr. Hung Tai Wang; see also copy of Nu Skin earnings printout (January 1991).

[11]Telephone interview with Larry Hodapp, attorney with the Federal Trade Commission (February 1990); telephone interview with Tom Inglehardt, attorney with the North Dakota Attorney General's office, (February, 1990). In the summer of 1991 Nu Skin was charged by the state of Michigan with being an illegal pyramid. The charges were dropped later that year.

[12] Scott interview, supra note 5.

[13] "Howard Ruff Hired as Chief Executive of FundAmerica," Los Angeles Times, July 31, 1990, at D1, col. 5.

FundAmerica grossed $33 million in revenues.[14] Membership entitled individuals to discounts of up to 20 percent on items ranging from flowers to long-distance phone calls. The big attraction of the FundAmerica plan was, however, the potential to earn big money by selling new memberships and by recruiting others to do the same.[15]

The problems with FundAmerica were threefold: 1) the promised savings of the discount never really amounted to much, so individuals were not really purchasing a legitimate product or service; 2) the memberships were being purchased and stockpiled primarily by those involved in the plan and were rarely sold to retail customers; and 3) prospective distributors were led to believe by those already involved that they could earn thousands of dollars in a matter of months with the program.[16] When the Florida Attorney General took action, the 100,000 distributors were holding some 800,000 surplus memberships. Stuck with all these memberships, most FundAmerica distributors lost money. For example, George Rust, a Long Island native, not only quit his $190,000-per-year job in order to work FundAmerica full-time, but he also lost the $25,000 he invested in FundAmerica for office rent, travel and other expenses.[17] Interestingly, Founder

[14] "100,000 FundAmerica Customers Couldn't be Wrong, Could They?" Business Week, September 3, 1990 at 40.

[15] Id.

[16] Id.

[17] "Behind FundAmerica's Appeal," San Francisco Chronicle, Sept. 4, 1990, at C1, col. 1.

Roberts had been charged in the past with operating illegal pyramid scams in Canada, Britain, and Australia.[18]

The cases of Corporate Suites, Nu Skin, and FundAmerica demonstrate the impact–whether positive or negative–that pyramiding and multilevel marketing have. Corporate Suites is an example of a pyramid where most participants lost money because of the nature of the marketing plan. This case also demonstrates some of the jurisdictional problems that currently face states in their attempts to regulate pyramids. Nu Skin is an example of a company that has had a positive impact on many people's lives and has made some individuals wealthy. The fact that Florida almost brought pyramid charges against Nu Skin but then "decided it was not a pyramid"[19] indicates the confusion surrounding pyramid laws today. That FundAmerica was able to continue for almost four years and garner 100,000 distributors is another example of the lack of clear legal guidelines through which to bring swift action against pyramids.

This paper first examines the history of multilevel marketing, including its ancestors: the chain letter and pyramids. The paper then discusses the ineffective attempts to outlaw pyramids, to regulate legitimate multilevel marketing companies, and to devise a bright-line test that can distinguish between the two methods. The paper then briefly analyzes the Pyramid Sales Act of 1974, the only federal regulatory proposal

[18] Business Week, supra note 13, at 40.

[19] Scott interview, supra note 5.

in this area that has been considered by a congressional committee. Finally, this paper proposes federal legislation that would integrate the best features of current regulations into a more effective and enforceable package. Federal legislation would outlaw any marketing structure using geometric progression that does not follow the federal guidelines. Such illegal activities would be deemed pyramids. Companies that do follow the proposed federal guidelines would be considered legitimate marketing companies using multilevel marketing as an appropriate method of distribution. Federal legislation, it will be argued, would best protect the consumer from pyramids and offer much needed legitimacy to the multilevel marketing industry.

I. A Brief History of Multilevel Marketing

A. The Chain Letter

"The concept of using a geometric progression to establish control within an organization, or to pass along information, has been present for centuries."[20] The idea of using the concept of

[20] Dr. Michael P. Harden, **The Handbook of Multi Level Marketing -Understanding Multilevel Sales Programs, Direct Selling, and Pyramids**, Promontory Publishing, Inc. (1987) at 45. Harden notes that primitive societies would pass legends and other tribal information on to younger members of tribe who would then pass it on to the next generation etc. He notes that Clare Boothe Luce asserted that early Christians had "pyramided" their membership from twelve (the Apostles) until it covered the entire Roman Empire.

"pyramiding" to generate income, however, was not used until the years following World War I when a chain letter craze began to sweep the country.[21] In the 1930s the "Send-A-Dime" chain letters became a phenomena of enormous proportions.[22] An excerpt from a 1935 New York Times article describes the "Send-A-Dime" scheme that started in Denver, Colorado:

> The recipient is requested to send a dime to the person at the top of the list. He then writes his own name and address at the bottom of the list, makes five copies of the letter and with the new list sends them to friends, who are supposed to keep the chain going. [23]

The geometric progression grew so rapidly that by April, 1935, almost every family in Denver had received one or more letters.[24] One individual was inundated with so many letters from his friends that he had to publish an advertisement in his local newspaper. He stated: "I have so far received 2,300 of these send-a-dime and send-a-buck letters . . . I can't answer them and they are delaying my legitimate business correspondence . . . Please, friends, don't send me any more." [25]

As the craze spread across the country, the postal service statisticians estimated that ten million chain letters were being

[21] Id. at 46.

[22] Id.

[23] "Chain Letter Fad a Post Office Pest," New York Times, Section IV, April 28, 1935, p. 11.

[24] Harden, supra note 20.

[25] New York Times, supra note 23, at 31.

mailed every day.[26] The postal revenues increased $300,000 as a result of this phenomena.[27] The postal service published reports demonstrating that only a small percentage of participants, those who got involved before everyone else did, could make any money in these schemes.[28] In the end, the post office was able to use various weapons quite effectively in their attempts to stop the chain letters, including postal regulations covering lotteries, mail fraud, and "endless chain" enterprises.[29] As a result, the chain letter phenomenon subsided markedly during the early 1940s after its peak in the late 1930s.[30]

B. Pyramid Clubs

Pyramid Clubs were created as a new version of the chain letter, with delivery made by hand to circumvent the postal regulations.[31] One article described the process:

> New members are recruited at a dollar a head at neighborhood parties, at which the customary refreshments are coffee and doughnuts. For his dollar the recruit has his name placed at the bottom of a pyramid-shaped chart . . . He then enlists two more

[26] Harden, supra 20, at 51.

[27] Id.

[28] "Dime Chain Letters Are Ruled Illegal," New York Times, May 8, 1935, p. 4.

[29] Id.

[30] Harden supra note 20, at 55.

[31] " Pyramid Club Craze Sweeps Nation," Life, March 7, 1949, Vol. 26, No. 10 p. 27.

> newcomers, each of whom has to find two more. Each moves him up toward the top of the pyramid, as he would move up on a chain letter, until finally he has the No. I spot.[32]

Pyramid Club pandomonia swept the country much the way its chain letter predecessor had years earlier.[33] It was estimated that hundreds of thousands of people were participating in New York alone during the late 1940s.[34] The problem with Pyramid Clubs is generally the same as that of chain letters; there is no way the pyramid can grow indefinitely without collapsing.

> For one chart to split in two 25 times it would take 33 million players. So sooner or later, charts 'die' as they run out of fresh recruits. The last players in not only don't make it to the top, they never recover their original [investment].[35]

Pyramids were declared illegal in most states. They were either specifically prohibited by statute or declared illegal under antigambling statutes.[36] While still seeing some occasional

[32] The article also notes the democratizing effect the Pyramid Clubs had on communities in the U.S.:

> One well-to-do matron threw a pyramid party and found that her guests included two cab drivers, a plumber, her cleaning woman, and her cleaning woman's husband. Since all felt equally larcenous at the moment, a good time was had by all.

[33] Harden, supra note 20, at 59.

[34] Id.

[35] "A View From the Top of a Pyramid Club," Money, August 1980, p. 67.

[36] Id. See also infra notes 117-126 and accompanying text.

activity today,[37] the Pyramid Clubs began to wither away in the early 1950s much as the chain letter schemes had died off in the early 1940s.[38]

C. Multilevel Marketing

With entrepreneurs realizing the potential of pyramids through geometric proliferation, it is not surprising that the pyramiding techniques were soon applied to the marketing of products and services. The first multilevel marketing (MLM) company, Nutrilite, was started in 1945 by Lee Mytinger and William Casselbery.[39] Nutrilite's nutritional products were sold through a marketing plan that is now used as a model for many MLM companies.[40] Nutrilite distributors would buy their supplies from the company at a 35% discount. The distributor could earn a monthly bonus of as much as 25% of his/her monthly sales volume. If he/she was able to get 25 customers to purchase

[37] See "A View From the Top of a Pyramid Club," Money, August 1980, p. 67. The chance to make “easy money” has, however, kept pyramids from completely dying off despite their illegality. Today, players will put up as much a $1,000 to buy a spot on the chart. Half of the $1,000 is given to the player at the top of the pyramid and the other half to the person who recruited him. With 32 players in the chart the top player would collect $16,000. Then the chart splits creating two new pyramids with the next two players each moving to the top of their own pyramid. Everyone else moves up until they reach the top of their respective pyramids.

[38] Harden, supra note 20, at 62.

[39] "The Mess Called Multi-Level Marketing," Money, June 1987, at 144.

[40] Id.

a month's supply of product, he/she was made a sponsor. Retail customers and distributors could now buy directly from him/her. The sponsor made a 35% profit on sales to customers and as much as 25% of sales from distributors that he recruited. When the sponsor and his/her distributors garnered 150 customers, he/she become a leader at the top of his/her pyramid. Once his/her distributors became leaders at the top of their pyramids, the original sponsor got 2% of their sales.[41] Thus, by seeking additional recruits to sell the company's products, the distributors could enlarge their own pyramid, from which they could realize extremely large commissions as each successive level attempted to expand its own system of distributors.

The founders of Nutrilite realized several distinct advantages of MLM as compared to other methods of distribution.[42] These advantages include the following:

1. Because the business relies on word-of-mouth sales, an MLM company does not need to spend much money on marketing and advertising costs.

2. Since MLM companies do not pay salaries to distributors and only pay commissions when products are sold, they are risking no money up front on their sales force.

3. MLM companies can motivate their distributors by offering higher commissions on increased sales within their groups.

[41] Id. at 145.

[42] Id.

MLM also offers individuals who do not have much start-up capital the opportunity to own their own business by becoming a distributor for a MLM company. In many cases, successful MLM distributorships have been started for less than $500.[43] Compare this with the costs of opening a franchise which in many cases can cost hundreds of thousands dollars.[44]

In the late 1950s, two of the most successful MLM companies in the industry were started: Amway and Shaklee. Founded in 1959 by two former Nutrilite distributors, Amway is considered the "granddaddy" of MLM. Amway has over one million distributors in the United States, Australia, Hong Kong and other parts of the world. Today the company offers over 5,000 different products and services, many of which are brand name items. Retail sales have grown from $500,000 in 1960 to $1.2 billion in 1983 to over $3.1 billion in 1991.[45] Shaklee, known primarily for its vitamin and cleaning products, had sales of over $400 million in 1986 and is publicly traded.[46]

Unfortunately for the MLM industry, there have been many unscrupulous individuals who have used this type of "chain selling" simply as a device to defraud the public. These

[43] Telephone interviews with various MLM distributors (January 1991-March 1991).

[44] For example, most McDonald's franchises now cost over $500,000.

[45] Keegan, supra note 6, at 34. See also "The Power of Inspiration", Forbes, December 9, 1991 p. 243.

[46] Harden, supra note 20, at 80.

pyramids are largely responsible for suspicion, by the public and regulatory authorities, of the entire MLM industry.[47] A survey of the key court decisions in this area of the law will make clear the differences between a legitimate MLM company and a pyramid scam. While these court decisions do give clear guidelines, it will be argued that a federal statute would better protect the consumer and legitimize the MLM industry.

Perhaps the largest pyramid scam of all time was Holiday Magic, Inc.[48] The Securities and Exchange Commission charged Holiday Magic with taking more than $250 million from 80,000 investors.[49] In return for investing up to $5,000 in the company's products, investors were granted the right to recruit other investors, who were then granted the same type of franchise right to recruit others, and so on, in what amounted to an endless chain or pyramid. In an earlier decision in California, the court pointed out that pyramiding is not concerned primarily with retailing a product but instead seeks the right to sell.[50] While a small percentage of products are marketed, financial success depends on recruiting other distributors into the chain. When the supply of recruits runs

[47] Roney interview, supra note 7.

[48] 84 F.T.C. 748 (1974).

[49] See complaint in S.E.C. v. Holiday Magic, Inc. et al. U.S. District Court, Northern District of California, Docket No. 73-1095 L.H.B.

[50] People v. Bestline Products, Inc. 61 Cal. App. 3d 879, 132 Cal.Rptr. 767 (1976).

out, the new prospects are left with a large supply of product which they are unable to move.[51] The SEC investigation found that Holiday Magic's marketing plan required a large, nonrefundable headhunting fee for the right to recruit others and placed little or no emphasis on retailing. The SEC also found that 90% of all investors were inactive and that the active members averaged a total return of less than $100.[52]

Concluding a ten-month investigation of Holiday Magic in 1973, Bess Myerson, then New York Consumer Affairs Commissioner, stated:

> The evidence we have compiled indicates that Holiday Magic is not a company that sells cosmetics but a carefully worked out scheme to keep increasing the number of people who can be deprived of their life savings. Victims all over the United States have gone into debt, lost their jobs and their health through participation in these pyramids.[53]

Based on the guidelines offered in Holiday Magic, four characteristics of a pyramid become clear: 1) inventory-loading - the requirement that new distributors must purchase a substantial amount of nonreturnable inventory to become involved in the business; 2) headhunting fee - the payment to a sponsor by the company for the mere act of recruiting a new distributor.[54] 3) no retail sale requirement - the fact that retail sales are

[51] Id.

[52] Harden, supra note 20, at 69.

[53] Harden, supra note 20, at 70.

[54] Rodney K. Smith, A Lawyer Looks at Multilevel Marketing, 48 (1984).

not stressed or required in order for the distributor to earn commissions; and 4) misleading income statements - the implication by the company or distributors that anyone can get rich easily and quickly without working hard. [55]

A case a year earlier, S.E.C. v. Glenn W. Turner Enterprises, Inc. 474 F.2d 476 (9th Cir. 1973), demonstrates how the courts were already applying similar standards to determine whether a company was a pyramid. Under the plan, Dare to Be Great, Inc., promoters offered the public a series of contracts referred to as "adventures."[56] An individual had to pay a highly-inflated fee for an instructional package on self improvement and for the opportunity to receive commissions on his recruits' sales of "adventures." The court found this to be an illegal pyramid on three grounds: 1) a headhunting fee was paid to distributors if they got someone new to purchase a large amount of inventory; 2) the investor who wanted the right to recruit other distributors had to buy a substantial amount of nonrefundable inventory; 3) much of the literature and many of the meetings held by the company stressed that a great deal of money could be made with little or no effort.[57]

Ger-Ro-Mar v. F.T.C. 518 F.2d 33 (2d Cir. 1975) is the only Commission case that was tried on the theory that a pyramid sales plan, apart from any particular misrepresentations, is inherently

[55] Id.

[56] Id. at 49.

[57] Id. at 50.

deceptive due to the inevitability of market saturation.[58] In Ger-Ro-Mar, the Commission found that the company was engaged in the sale and distribution of "Sembra'ett" brand brassieres, girdles, lingerie, and swimwear through a multilevel marketing plan. A distributor with the company obtained the right to purchase products at a discount and sell them at retail prices for a profit.[59] Distributors also obtained the right to recruit others into the company. The court upheld the Commission's determination that the earnings claims contained in the advertisements promoting Ger-Ro-Mar's pyramid sales scheme–as opposed to the pyramid plan itself–were deceptive. On the other hand, the court held that the marketing plan itself could not be held to violate Section 5 of the FTC Act based solely on a theoretical or mathematical formula.[60] The court stated:

> the sole evidence to support the Commission's holding that the plan is inherently unfair and deceptive is a mathematical formula which shows that if each participant in the plan recruited only five new recruits each month and each of those in turn recruited five additional recruits in the following month, and this process was allowed to continue, at the end of only 12 months the number of participants would exceed 244 million, including presumably the entire staff of the FTC.[61]

The court, noted, quite amusingly, that such mathematical

[58] Steiner and Stone, The Federal Trade Commission and Pyramid Sales Schemes, 15 Pac. L.J. 879, 884 (1984).

[59] Ger-Ro-Mar v. F.T.C. 518 F.2d 33 (2d Cir. 1975).

[60] Id. at 38.

[61] Id.

progression could never happen in the real world:

> We find no flaw in the mathematics or the extrapolation and agree that the prospect of a quarter of a billion brassiere and girdle hawkers is not only imp ossible but frightening to contemplate, particularly since it is in excess of the present population of the Nation, only about half of whom hopefully are prospective lingerie consumers. However, we live in a real world and not a fantasyland.[62]

The court vacated and set aside the opinion of the Federal Trade Commission and concluded that "the per se condemnation of the recruiting scheme disclosed here is not supported by substantial evidence or even a scintilla of evidence."[63]

The Holiday Magic, Glenn Tumer, and Ger-Ro-Mar cases all set the stage for the seminal case in pyramid-MLM law, the 1979 Amway Corporation. Inc. decision.[64] The decision legitimizes multilevel marketing as a viable form of marketing and also offers fairly clear guidelines to distinguish a legitimate MLM company from a pyramid scam. In the initial decision, Administrative Law Judge Timony stated:

> The Amway Sales and Marketing Plan is not a pyramid plan. In less than 20 years, [Amway has] built a substantial manufacturing company and an efficient distribution system, which has brought new products into the market, notably into the highly oligopolistic soap and detergents market. Consumers are benefitted by this new source of supply, and have responded by remarkable brand loyalty to Amway products. [65]

[62] Id. at 37.

[63] Id. at 38.

[64] 93 F.T.C. 618 (1979).

[65] Id. at 706.

Commissioner Pitofsky, who wrote the final opinion of the Commission, concluded that Amway had avoided the abuses of a pyramid scheme by:

1) not having a headhunting fee.[66] The only investment the system involved was a sales literature kit costing $15.60. This could be returned for a refund if the distributor decided to leave Amway;

2) making product sales a precondition for receiving the performance bonus. [67] The only way commissions could be earned was when products were sold. No fees for mere recruiting were paid;

3) buying back unsold inventory.[68] Amway required that distributors must buy back the inventory of any of their sponsored distributors leaving the business;

4) requiring a substantial percentage of products be sold to consumers at retail. [69] Distributors had to certify that they each sold to ten retail customers every month.

Pitofsky did warn Amway not to misrepresent potential earnings, and he stipulated that if Amway literature was to give hypothetical examples of earnings, the literature would also have to indicate the percent of all distributors who actually achieved

[66] Id. at 716.

[67] Id. at 722.

[68] Id. at 723.

[69] Id.

such stated profits.[70]

The Amway decision gave MLM a much needed boost. Armed with the legitimacy of an FTC decision, MLM companies began to prosper. A.L. Williams Corporation, an insurance MLM company founded in 1977, had a slow beginning, but within the last 10 years it has garnered nearly 200,000 agents selling its products. As of 1989, A.L. Williams had active policies totaling $273 billion in death benefits and is writing more individual life insurance than any other company in the United States.[71] Since the mid 1980s, U.S. Sprint and MCI have amassed in excess of three million customers using MLM.[72] Matol Company, founded in 1984, is now doing over $250 million a year in business from the sale of one nutritional product.[73] Within the past few years many Fortune-500 companies, including the Rexall Drug Company, General Motors, Ford, Chrysler, Fisher, and Bill Blass have started using MLM as a form of distribution.[74] The reduction in risky advertising costs and extremely quick growth potential are two of the main reasons for large established companies to

[70] Id. at 738.

[71] "Ex-Football Coach Art Williams Runs a Winning Insurance Firm, But some People are Crying Foul," Peop1e Magazine, November 20, 1989, 161.

[72] Babener and Stewart, The Network Marketing Guide to Success 6 (1990).

[73] According to several Matol distributors, they added one other product in 1990.

[74] Poe, Network Marketing: The Most Powerful Way to Teach Consumers in the '90s, Success, May 1990, p. 74.

utilize MLM as a form of distribution. Currently, there are approximately 1,200 MLM companies and approximately 12 million distributors in the United States.[75] Some estimates put MLM sales growth at 30% a year and annual sales at $20 billion.[76] At least one publication has predicted that by the late 1990s, more than 50 percent of all U.S. goods sold to the public will be marketed through MLM.[77]

Not only are MLM companies prospering, but some distributors are also making substantial financial gains. In an informal survey of 50 MLM distributors[78] around the country who have been involved with an MLM company for at least a year, I found that 8 had made no profit at all, 16 were earning between $1,000 and $3,000 profit per month, 9 were earning between $3,000 and $10,000 per month, 7 were earning between $10,000 and $20,000 per month profit, 6 were earning between $20,000 and $100,000 per month profit, and 4 were earning over $100,000 per month profit.[79]

[75] Phone interview with Doris Wood, President of the MultiLevel Marketing International Assn. (MLMIA), (February 1991).

[76] Id.

[77] McLellen, The Secretes of the Pyramid, 42 Director 31, (September 1988). Note also the growth in the foreign market. Amway Japan, with annual Japanese sales in excess of $600 million, is one of the 10 fastest growing foreign corporations in the world. See Babener, supra note 68, at 6.

[78] Most MLM companies will not disclose distributor income data claiming that this is personal information that must be obtained from the individual distributors.

[79] Personal Interviews with various MLM distributors around the country (September 1990 - March 1991).

Given the clear legal guidelines offered in the Amway decision, it is surprising that pyramid sales schemes that illegally deceive most participants are still proliferating across the nation. Indeed, schemes such as Corporate Suites and FundAmerica represent a small portion of the illegal pyramid scams in the United States. Staff attorneys in the Federal Trade Commission's San Francisco Regional Office believe that pyramid sales of over $100 million by 100 firms would be a conservative estimate of the size of the problem.[80] As we shall see, confusing, burdensome, and inconsistent state-by-state regulation, most of which does not take into account the Amway decision, is a primary reason for the abundance of abuse. Jurisdictional and constitutional problems also cut into state regulations. A lack of resources to address a problem that is often merely regional in scope prevents the SEC and the FTC from clamping down effectively.[81]

At the same time, legitimate MLM companies endure prohibitive legal costs and fears of being prosecuted due to the

[80] Stone and Steiner, supra note 56, at 879. The authors note that estimating the size of the pyramid sales industry is difficult because no industry statistics are available and because of the transitory nature of the companies in the industry.

[81] In fact, the FTC has not brought any "pyramid" claims against pyramid or MLM companies since the 1979 Amway decision. Phone interview with Larry Hodapp, attorney with the Federal Trade Commission, (April 1991).

hodgepodge of pyramid and MLM laws across the country.[82] According to Jeffrey Babener, an MLM law specialist, "Given the inconsistency in state and federal laws as well as the inconsistency in enforcement activity, it is really impossible to give a legal stamp of approval to any MLM program."[83]

As the next section will show, the current measures and regulations designed to prevent pyramid scams from proliferating are not only ineffective, but they subject legitimate MLM companies to prohibitive legal costs and prosecutorial fears. The final section will propose federal legislation that strikes a balance between protecting consumers from pyramid scams and allowing MLM companies to operate freely in the marketplace.

II. Regulatory Attempts

Consumers ordinarily protect themselves in the marketplace by choosing among alternative products or among alternative uses of money, time, and labor. For this decision to be meaningful, it must be based on full and accurate knowledge of the various alternatives.[84] Pyramid promoters often undermine this process

[82] Of the five MLM companies that I interviewed (Amway Corporation, Images International, Nu Skin International, and Omnitrition International) only Amway stated this was not a real concern of theirs.

[83] Phone interview with Jeffery Babener, MLM attorney (November 1990).

[84] See generally Pridgen & Preston, Enhancing the Flow of Information in the Marketplace: From Caveat Emptor to Virginia Pharmacy and Beyond at the Federal Trade Commission, 14 Ga. L.

by misrepresenting the earnings potential of their distribution programs,[85] thus making informed comparisons by prospective participants very difficult.[86] A pyramid promoter has little or no incentive to provide reliable information because the financial success of the scam is often dependent upon false promises.[87]

Reliable information about a pyramid opportunity will be slowly disseminated to the market only after disgruntled participants both fail to achieve the promised earnings and make their dissatisfaction known to other potential participants.[88] In the meantime, new distributors, deceived by the promotion, will continue to enter the scam. Pyramids are designed to exploit the information failure of the market by moving in and out of the market quickly.[89] As a result, regulatory action within the industry and on the federal and state levels has been seen as a means to combat pyramids.

Rev. 635 (1980); Pitofsky, Beyond Nader: Consumer Protection and the Regulation of Advertising, 90 Harv. L. Rev. 661 (1977).

[85] See, e.g., Ger-Ro-Mar, Inc., 84 F.T.C. at 149-150; Holiday Magic, Inc., 84 F.T.C. at 1032-35.

[86] Steiner and Stone, supra note 56, at 893.

[87] Id.

[88] Id.

[89] Id.

A. Federal Regulations

(1) Federal Trade Co and Securities & Exchange Commission

Neither the FTC nor the SEC possesses effective weapons to curb pyramid schemes or to regulate MLM.[90] While the FTC and SEC have taken some steps to address the pyramid problem, their "procedures are time consuming, their statutes are not specifically tailored to deal with this scheme, and their personnel are limited."[91] Since the 1979 Amway decision, the FTC has not brought a single "pyramid" action against a pyramid or a MLM company.[92] Regulation by the FTC usually attacks the pyramids for fraudulent practices and structure, but a very slow adjudication process and the uncertainty of the FTC's power to issue and enforce substantive trade regulation rules hamper this approach.[93] The necessity of classifying an interest in a

[90] Pyramid Schemes: Dare to be Regulated, 61 Geo. L.J. 1257, 1293 (1973).

[91] Hearings on SB 1939 Before the Subcommittee for Consumers of the Committee Commerce, 93rd Congress, 2d Session 15 (1974) [hereinafter Hearings] (testimony of Senator Walter Mondale). Others who have been active in fighting pyramid sales organizations are advocates of federal legislation. Dean W. Determan, former Vice President for Government and Legal Affairs for the Council of Better Business Bureaus, stated in a letter to Senator Walter Mondale:

> While the Federal Trade Commission and the Securities and Exchange Commission are both taking actions in this sphere of business activity, their rules and orders are directed against individual companies and promoters, and each action takes a long time to accomplish.

Cong. Rec. 16189 (daily ed. Sept. 28, 1972).

[92] Hodapp interview, supra note 79.

[93] Pyramid Schemes, supra note 88, at 1293.

pyramid scheme as a "security" makes securities regulation a circuitous route when more direct routes could be made available. [94]

B. Non-Governmental Regulations

(1) The Direct Selling Association

The Direct Selling Association (DSA) is a voluntary association whose membership includes almost all of the large corporations involved in direct sales (door-to-door) and also several of the large MLM companies. The members follow a self-imposed code of ethics, which is strictly enforced by the DSA and which has done a great deal toward improving the image of MLM companies in the eyes of the general public.[95] MLM members appear to be legitimate MLM companies. [96]

Unfortunately, the main shortcoming of the DSA renders its guidelines ineffectual. The DSA's status as a voluntary organization means that the DSA and its rules are not binding on nonmembers. Since the DSA cannot compel pyramids or MLM companies to join the association, companies prone to abuse can evade regulation simply by not joining the association. Second, the only enforcement mechanism that the DSA has when finding a violation is revocation or suspension of the MLM

[94] Id.

[95] Ella, Multi-level or Pyramid Sales Systems: Fraud or Free Enterprise, 18 S.D.L. Rev. 358, 392 (1973).

[96] Phone interview with Mario Brossi, attorney with the Direct Selling Association, (February 1991).

company's membership, or civil penalties. No criminal sanctions, which may be the most effective deterrent, can be brought by the DSA.

(2) Multi-Level Marketing International Association (MLMIA)

The MLMIA currently has about 90 corporate members and about 90 support members. Its membership includes lesser known MLM companies such as Network 2000, which sells US Sprint services and Omnitrition, a nutritional company in Dallas. According to MLMIA President Doris Wood, the association is primarily an information center. [97] Its goal is to educate people within business and industry, as well as consumers, about the legal and ethical workings of a legitimate MLM company. The MLMIA has a code of ethics that it encourages it members to adhere to. It also will investigate complaints it receives about a particular company, ask the company to rectify the problem if the complaint is legitimate, and notify the proper regulatory body in the company's area if the problem is not corrected. [98]

The effectiveness of the MLMIA in curbing pyramiding and unscrupulous MLM practices is even more limited than that of the DSA. First, as with the DSA, since the MLMIA is a voluntary organization, its code of ethics is not binding on nonmembers. Again, pyramid promoters can evade the code of ethics and

[97] Phone interview with Doris Wood, MLMIA President, (February 1991).

[98] "Q & A: Doris Wood, Direct Marketing's Other Side," Los Angles Times, August 20, 1990 at Part D, Page 6, col. 1.

investigation by the MLMIA by simply not joining the association. Moreover, the code of ethics is not binding on members, since adherence is only encouraged and not mandatory. While the MLMIA may certainly lend some legitimacy to the MLM industry, its power to curb pyramids is limited to reporting abuses to the proper authorities.

C. State Legislative Attempts

State legislation has three significant advantages over nonlegislative regulation. First, legislation can require that all pyramids or MLM companies abide by certain rules. The regulatory impact under legislative implementation is not limited by the voluntary status that hampers the DSA or the MLMIA. Second, legislative authority adds teeth to the regulations by making criminal sanctions possible. While the DSA and MLMIA can threaten revocation, suspension, or civil penalties, a legislature's imposition of criminal sanctions may act as a more effective deterrent against pyramids. Third, the state's proven enforcement power poses a far more tangible threat to pyramid scam artists than do the untested enforcement mechanisms of the non-legislative regulations.

State statutes that affect pyramids or MLM companies fall into six areas of the law: statutory fraud, lottery statutes, franchise law, business opportunity statutes, buyer's club statutes, and most importantly, "pyramid" statutes and MLM

registration laws.[99] After noting the first five theories, this paper will take a closer look at the "pyramid" statutes and MLM registration laws. This inquiry will clarify why specific uniform legislation for this area of the law is needed.

(1) Statutory Fraud

As applied to multilevel marketing, fraud is anything which is designed to induce any participant to part with money or goods based on exaggerated and false promises, claims, or any form of words or actions which are not grounded in the truth.[100] Aside from fraud actions that can be brought against a particular MLM company for false claims, companies are frequently plagued by over-zealous and sometimes unscrupulous distributors who make claims and promises which are unrealistic or even untrue.[101]

[99] Phone interview with D. Jack Smith, MLM attorney, (February 1991).

[100] D. Jack Smith Fifty State Multilevel Marketing Law Compendium (1988). See also SEC v Capital Gains Research Bureau, Inc. 375 U.S. 180 (1963).

> Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealment which involve a breach of legal or equitable duty, trust, confidence, or by which an undue an unconscientious advantage is taken of another.

[101] Id. See State ex. rel. Turner v. Koscot Interplanetary, Inc., 191 N.W.2d 624, 628 (Ia. 1971); Kugler v. Koscot Interplanetary, Inc., No. C-2603-70 (Super. Ct.Essex County, N.J. July 26, 1972):

> One prospect, told that he could triple his income with the same effort he was then exerting in his work, bought a distributorship in December, 1970, only weeks before Koscot abruptly stopped all such sales on February 3, 1971.

If fraud seems deliberate from the facts, the courts will find against a company where the company either knew or should have known or taken adequate steps to control information from the home office or its distributors. The courts are adamant in preventing the public from being victimized by untrue statements or claims.[102] Unfortunately, many pyramid and MLM problems have little or nothing to do with fraud[103] and thus cannot be challenged under this theory.

(2) Lottery Statutes

Pyramids have been successfully attacked under the lottery statutes of some states.[104] The elements of a lottery are consideration, prize and chance.[105] In any pyramid, the elements of consideration and prize are usually present with the participant paying a sum of money for the privilege of joining the marketing plan (consideration) and hoping to receive a return

[102] Smith interview, supra note 97.

[103] For example inventory loading or nonrefundable product sales have nothing to do with false promises or claims.

[104] State ex rel. Kelley v. Koscot Interplanetary, Inc., 195 N.W.2d 43 (Mich. App. 1972); Fry v. Taylor, 3 Blue Sky L. Rep. § 71,020 (Fla. App. 1972); See also Commonwealth ex rel. Speaker v. Koscot Interplanetary, Inc. Equity Docket No. 57 (C.P. Erie County, Pa. 1970). Contra, State ex rel. Sanborn v. Koscot Interplanetary, Inc., No. C 22475 (Dist. Ct. Sedgwick County, Kan. 1972).

[105] State ex rel. Frizzell v. Highwood Service, Inc. 205 Kan. 821, 473 P.2d 970, 99 (1970); Sproat-Temple Theatre Corp. v. Colonial Theatrical Enterprise, Inc. 276 Mich 127, 267 N.W. 602, 603 (1936).

higher than his investment (prize) by sponsoring others.[106] The element of chance has given the courts the most trouble in applying the lottery statute.[107] In State ex rel. Kelley v. Koscot Interplanetary. Inc.,[108] the court ruled that the element of chance was satisfied by the fact that by bringing a prospect to an "opportunity meeting," where the business is shown to potential distributors, the distributor is relying on the ability of the operators of that meeting and not on the distributor's own efforts. [109]

Another difficulty in the lottery attack is in defining the evil that the lottery statute is intended to remedy.[110] In People v. McPhee,[111] the court acknowledged the fact that the Michigan statute[112] did not define the word "lottery," stating:

The word 'lottery' is generic. No sooner is it defined by a court than ingenuity evolves some scheme within the mischief discussed but not quite within the letter of the definition given.[113]

Technically, any pyramid or multilevel marketing company

[106] Ella, supra note 93, at 370.

[107] Id.

[108] 195 N.W.2d 43 (Mich.App. 1972).

[109] Id. at 54.

[110] Ella, supra note 93, at 370.

[111] 139 Mich. 687, 103 N.W. 174 (1905).

[112] Section 11.344 Mich Comp. Laws (1897) now Mich Comp. Laws § 750.372 (1948).

[113] People v. McPhee, 139 Mich. at 690-91, 103 N.W. at 176 (1905).

that requires a distributor to make any payment to participate in the marketing plan could be held to be a lottery.[114] This would even include the $15 sales kit that the Court in Amway decision ruled did not constitute an investment.[115] As a result, legitimate MLM companies are often attacked under the lottery statutes because of prejudice within some governmental agencies against the MLM industry.[116]

Other statutes that could potentially[117] be used against pyramids and MLM companies are franchise law statutes, [118] business opportunity statutes,[119] and buyer's club statutes.[120]

[114] Smith interview, supra note 97.

[115] See supra note 64 and accompanying text.

[116] Smith interview, supra note 100.

[117] While the potential for use exists and may be out there, as of March 1992, no cases could be found where these statutes were actually used against a pyramid or MLM company.

[118] The United States Federal Trade Commission has defined a "franchise" as the offering of any opportunity which involves (1) the payment of 500 or more dollars on a annualized basis, (2) the use of a uniform logo or trademark and (3) a marketing plan that is "substantially prescribed" by the seller. Interview with Smith, supra note 97. Most states have also adopted this standard definition of a franchise. Obviously, if an MLM or pyramid does not charge $500 or more on an annual basis it could not be charged under the franchise law statute. No cases could be found where a pyramid or MLM company was charged under a franchise statute.

[119] According to MLM attorney D. Jack Smith, twenty-six states have adopted laws similar to franchise law to govern the sale of certain "business opportunities" which do not cost more than $500 on an annualized basis. Most of the business opportunity statutes do not apply unless a company is charging in excess of $50.00 in order to acquire the right to go into business form the seller of that right. Thus, pyramids like Corporate Suites, might be covered under such a statute.

All six of the statutory methods above have played or could play a minor role in curbing unlawful pyramids and regulating legitimate MLM companies. This hodgepodge of statutes, however, has not provided enough protection for consumers from pyramid scams and has not shielded legitimate MLM companies from undue harassment from governmental agencies. It is not surprising then, that many states have looked to Pyramid Statutes and MLM Registration Laws to combat this problem.

(3) Pyramid Statutes

At least 39 states have legislation dealing with pyramid sales,[121] endless chain sales,[122] and multilevel sales

[120] According to D. Jack Smith these statutes were enacted in response to a number of fly-by-night store front operators who sold memberships and took deposits from an unsuspecting public and then fled the state. It is extremely rare when an MLM company has to register under a state's buyer's club law since MLM companies do not normally sell such memberships.

[121] See Code of Alab. 8-19-5 (19-20) (1984); Ariz Rev. Stat. Ann. § 44-1731 (Supp. 1989); Ark. Stat. Ann. § 70-905 (Supp. 1990); Col. Rev. Stat. 6-1-101 (Supp. 1990); Mitchie Del. Code Annot. § 2561 (1990); Ill. Stat. Ann. § 17-7 (Supp. 1990); Ky Acts 367-830 (Supp. 1990); Mich Stat. Ann. 19.854 § 28 (1990); Miss. Stat. Ann. § 75-24-51 (1990); Mo. Rev. Stat. § 407 (Supp 1990); Neb. Rev. Stat. § 87-301 (1990); Nev. Rev. Stat. § 598.100 (Supp. 1990); N.M. Stat. Ann. § 57-13-2 (1990); N.C. Ben Stat. § 14-291.2 (Supp 1990); Ohio Rev. Code Ann. § 1333.91 (1990); Or. Rev. Stat. 646.608 (1990); Pa. Stat. tit. 73 §§ 201-1 to 3 (Supp 1990); S.C. Code Ann. § 39-5-30 (1990); Tenn. Code Ann. §39-6- 625 (1990); Utah Code Ann. §76-6a-1; Va. Code Ann. § 18.2-239 (Supp. 1990); W.Va. Code Ann. §§ 47-15-1 to 47-15-6 (Supp 1990).

[122] See Alaska Stat. § 45.50.471 (19-20) (Supp. 1990); Cal. Code § 327 (West 1991); Haw. Stat. Ann. § 480-3.3 (Supp. 1990); Mont. Code Ann. § 45-6-319 (1990); N. H. Rev. Stat. Ann. § 358 (1990); N.Y. Law § 359 McKinney (1990); Tex. Code Ann. § 32.48 (1990); Wis. Stat. Ann. § 122.01 (1990).

plans.[123] The majority of these statutes were enacted in the early 1970s.[124] In most instances, these statutes define a pyramid or endless chain scheme as a program in which a participant gives valuable consideration for the chance to receive compensation or something of value by procuring new participants for the program.[125] The majority of state laws dealing with pyramid schemes are prohibitory in nature.[126] Some of the state laws classify pyramid schemes as lotteries[127] which are either forbidden or heavily regulated by law in every state. While aimed at pyramid schemes, the anti-lottery laws offer no protection to potential investors because there are no provisions allowing for recovery by defrauded investors and few provisions regulating the pyramid scheme promoters themselves.[128]

The remaining prohibitory statutes outlaw pyramid schemes

[123] See Fla. Stat. Ann. § 2-17 (1990); Ga. Code Ann. § 10-1-411, 412 (1989); La. Rev. Stat. Ann. Tit 3 § 5001 (1990); Me. Rev. Stat. Ann. tit 17 § 2305 (Supp. 1990); Md. Ann. Code Art. 23 §180A (1990); Mass. Ben Laws Ann. ch. 93, § 69 (Cum. Supp. 1990); Okla. Stat. tit. 71 § 2 (1990); Wash. Rev. Code § 19.102.010 (Supp. 1990); Wyo. Stat. 40-3-101 (1990).

[124] Ella, supra note 93, at 380.

[125] See Nev. Rev. Stat. § 598.100 (Supp. 1990).

[126] All of the 39 statutes noted above are prohibitory in nature except for Georgia's, Maryland's, Massachusetts', Louisiana's, Washington's, and Wyoming's.

[127] See N.C. Gen. Stat. § 14-291.2 (Supp. 1990); Okla. Stat. tit. 71 § 2 (1990); Tenn. Code Ann. 39-6-625 (1990).

[128] Pyramid Schemes, supra note 88, at 1264.

either as unfair or deceptive trade practices[129] or as against public policy and therefore voidable by the participant or unenforceable by the promoter.[130] These prohibitory statutes offer more protection to the general public than the lottery laws by empowering the courts to prohibit the initiation or continued operation of any pyramid scheme,[131] to appoint a receiver to distribute the assets of the scheme or to reimburse participants, [132] and to impose misdemeanor penalties.[133] The provisions for restitution and the appointment of a receiver can sometimes permit the investor to obtain a meaningful recovery of his initial investment. [134]

Delaware's prohibitory statute contains an example of a comprehensive definition of a pyramid scheme. The Delaware statute outlaws pyramid distribution schemes and defines them as folIows:

'Pyramid or chain distribution scheme' means a sales device whereby a person, upon a condition that he part

[129] See Alabama, Arizona, Arkansas, Colorado, Delaware, Illinois, Kentucky, Mississippi, Missouri, Nebraska, New Mexico, Ohio, Oregon, Pennsylvania, South Carolina, Utah, Alaska, California, Hawaii, Montana, New Hampshire, Texas, Wisconsin, and Florida statutes.

[130] See Michigan, Nevada, Virginia, and West Virginia statutes. Note that New York treats pyramids and MLM companies as securities.

[131] See, e.g. Arkansas or Nevada.

[132] See, e.g. Arkansas and Nevada. Id.

[133] Arizona is the only state in the United States that makes operating a pyramid scheme a felony – the rest are misdemeanors.

[134] Pyramid Schemes, supra note 85, at 1264.

with money, property or any other thing of value, is granted a franchise license, distributorship or other right which person may further perpetuate the pyramid or chain of persons who are granted such franchise, license, distributorship or right upon such condition.[135]

Unfortunately, this definition, which is similar to many of the prohibitory statutes, is broad enough to include legitimate MLM companies as pyramid schemes. Under the 1979 Amway decision administrative law Judge Pitofsky held that a sales kit, which was refundable, could be a required purchase under the Amway marketing plan.[136] The Delaware statute does not leave room for this practice. In states such as Delaware, the life or death of an MLM company rests upon the mercy and discretion of the Attorney General in charge of overseeing MLM companies. [137] Overly broad statutes can be interpreted and enforced as liberally as the Attorney General's office wishes.[138] The prohibitory statutes were primarily a response to the blatant pyramid schemes of yesteryear.[139] Because MLM is such a specialized field, the outdated prohibitory statutes are confusing to apply, overly burdensome to MLM companies, [140]

[135] Mitchie Del. Code Annot. § 2561 (1990).

[136] See supra note 64 and accompanying text.

[137] Smith interview, supra note 97.

[138] Id.

[139] Smith interview, supra note 97. See, e.g. the Holiday Magic, Glenn Turner, and Ger-Ro-Mar cases noted earlier.

[140] See, e.g. Delaware statute.

inconsistent between states, [141] and designed to address only obviously illegal pyramids and not the unique problems associated with legitimate MLM companies. A more complete approach to handling the pyramid/MLM problem is through regulatory statutes.

(4) MLM Registration Laws

A small minority of state statutes are regulatory in nature.[142] Before being repealed in 1985, South Dakota required all multilevel or pyramid companies to register with the attorney general before doing business within the state.[143] The registration required complete disclosure and annual updating. The Attorney General's office was given the discretion to refuse registration. This law was viewed as a stop gap by some since it allowed the Attorney General's office to "effectively control the operation of any multi-level company within the state."[144]

Five of the six regulatory statutes[145] represent relatively well-drafted legislation that exhibits both a cognizance of the

[141] See, e.g. Delaware statute not allowing any fee to be charged to a new distributor and the Colorado statute which permits a fee of up to $100.

[142] See Georgia, Maryland, Mass, Louisiana, Washington and Wyoming statutes.

[143] S.D. Code §§ 37-25-3, 37-25-4 (Supp. 1990).

[144] Ella, supra note 93, at 382.

[145] Georgia's statute, which went into effect July 1, 1988, is very lengthy and quite ambiguous.The problem lies in that the statute tries to govern "Business Opportunities" and "Multilevel Marketing" in the same statute. The requirements for each, however, are often blurred and hard to separate. For more detailed explanation of the Georgia statute see D. Jack Smith, Fifty State Multilevel Marketing Compendium (1988).

right of legitimate companies to utilize this consumer distribution method in a free market while understanding the abuses that can appear. In 1971, Massachusetts adopted a statute entitled "Multi-level Distribution Companies Regulated. "[146] This statute is the most sophisticated and apposite of any pyramid or MLM statute in the United States.[147] In paraphrasing its most important points, the law provides:

(1) a broad definition of a "multi-level distribution company" which includes all distribution methods "wherein participants in the marketing program may recruit other participants."

(2) that every distributor contract shall allow for cancellation by the participant, and that all products in the participants possession, in a resalable condition, shall be repurchased at ninety percent of the original cost;

(3) that no MLM company shall require the purchase of more than reasonable quantities of inventory and that the company agrees to repurchase any of the required inventory at ninety percent of the original cost;

(4) that (i) no MLM company may operate in a manner primarily dependent upon the continued successive recruitment of other participants or where retail sales are not required as a condition for bonuses or compensation and (ii) no MLM company may

[146] Mass. Ann. Laws ch. 93, §69 (1991).

[147] See Ella, supra note 93, at 384. Ella advocates the adoption of the Massachusetts statute in other states. His analysis of the Massachusetts statute was used extensively in this paper.

offer financial rewards solely for the recruitment of other participants (no headhunting fees);

(5) that MLM companies shall not represent stated amounts of expected earnings; the company may, however, describe how the plan works. Nor shall the company represent that additional distributors or sales personnel are easy to secure or retain, or that all participants will succeed;

(6) that every MLM company with participants in the state shall file notice of that fact annually with the Attorney General and shall designate the state secretary its agent for service of process;

(7) that any violation of these provisions shall constitute an unlawful marketing method;

(8) that the attorney general is empowered to bring an action to restrain violations of the law.[148]

One ambiguous provision of the statute is that no MLM company may offer financial rewards where payment thereof is or would be dependent on the element of chance dominating over the skill or judgment of the participant.[149] Many of the top MLM entrepreneurs interviewed noted that their income really exploded when they found one "big hitter" who really worked the business to its full extent. The element of chance comes into play in every business opportunity; some businesses (i.e. oil exploration and refining) involve the element of chance more than others.

[148] Id.

[149] See Mass. Ann. Laws ch. 93, §69(d)(4).

That the chance element of MLM should be treated any differently than other business opportunities seems unjustifiable. The provision above provides no real guidance for enforcement officials and only seems to cloud the issue at hand.

Other than the "chance" provision, the Massachusetts statute effectively defines and prohibits most abuses which have given rise to complaints and which were discussed at length in the Amway decision.[150] The provision for contract cancellation neutralizes the effect of the high pressure "opportunity meeting," where a prospect can be swept along with no time for detached analysis of the plan or his own talents before he signs up. The repurchase clause assures that participants will not be victims of inventory loading under a nonrefundable purchase agreement. The act further prohibits a plan which is contingent on the recruitment of other participants without retail sales as a condition precedent of realization of financial gains. The representation of high incomes is also prohibited. The presentation of the marketing plan and its potential geometric growth is permitted, yet one cannot claim that all participants will automatically succeed. The filing notice with the attorney general's office will put the latter on notice as to the goings on within the state.

These provisions allow for legitimate MLM companies to recruit people who are interested in pursuing a business opportunity. Any multilevel marketing program falling outside

[150] See supra notes 62-68 and accompanying text.

these guidelines is considered an illegal marketing program. While preserving the freedom of the marketplace, the statute also protects consumers from some of the more blatant abuses in this type of marketing.

III. The Need For Federal Regulation

The inadequacies of confusing, burdensome, and inconsistent state-by-state prohibition and regulation of pyramids and MLM companies[151] call resoundingly for preemptive[152] federal regulation that would create uniformity in the law governing MLM companies, thus avoiding potential jurisdictional fights between states with distinct and perhaps inconsistent regulations.[153] Because most MLM companies have, or would like to have, distributors nationwide, conflicting state provisions would create a no-win situation for MLM companies who want to comply with both provisions.

[151] See also Hull, Pyramid Marketing Plans and Consumer Protection: State and Federal Regulation, 21 Journal of Public Law, Emory Law School 445, 474 (1972) ("Piecemeal litigation on a state-by-state basis has caused a wide variety of legal decisions and probably has resulted in substantial delay in effective and conclusive enforcement.").

[152] "[I]t is well established that within Constitutional limits Congress may preempt state authority…" Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977).

[153] The Delaware and Colorado statutes, for instance, differ on whether a marketing plan can require any fee whatsoever to become a distributor.

Another potential problem of state-by-state regulation, if more states turn to the regulatory method, is that MLM companies will have to shoulder an intolerable administrative and financial burden in order to comply with each state's filing notice, annual renewal and bond requirements. [154] Since states such as Georgia impose burdens of time and money on MLM companies before they can practice in the state, legitimate MLM companies may not want to shoulder the burden for a mere chance of garnering a large distributor following in that state. A potential distributor may therefore miss the opportunity to participate with a MLM company since the company may not think it worthwhile to go through the trouble in that state. Thus, instead of protecting a potential distributor, a state regulation might place the potential distributor at a disadvantage relative to those potential distributors in states without such regulations. Preemptive federal regulation would replace multiple application and bond requirements with one application and fee. Legitimate MLM companies would not be priced out of the market and potential distributors would have a broader field of distributors from which to choose.

State MLM laws could also be challenged under the United States Constitution. Under the commerce clause, Congress is authorized to regulate interstate and foreign commerce.[155]

[154] Currently only Georgia requires companies to purchase a $75,000 bond if they will be operating in the state.

[155] U.S. Const. art. I, § 8, cl. 3.

Federal regulation of MLM companies would appear to be within the commerce power because most MLM companies do operate simultaneously in many different states. For state statutory regulations of interstate commerce to be constitutional, they must pass the often-cited Pike v. Bruce Church, Inc. test:

> Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.[156]

A state's attempt to enforce its regulation against a MLM company with a few distributors within its jurisdiction may be challenged on the ground that the law's burden on commerce outweighs its benefits to the state. The MLM company could argue that the burdens of posting bonds and of complying with any disclosure and filing requirements are "clearly exc essive" in relation to the state's interest in regulating the MLM companies' few distributors within the state.

On the other hand, states deciding whether to enact MLM regulations may informally apply the Pike test. If the state has only a handful of MLM distributors who would be protected by the regulation, the state may conclude that the expense of enforcing the law and the potential burdens on MLM companies would outweigh the "local benefits." While the state would be saving time and money, the distrib utors would remain largely unprotected from problems of pyramid abuse. These distributors would be disadvantaged in comparison to distributors in states that

[156] Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

determined that regulatory benefits outweighed regulatory burdens. A federal law would reach into states that have no pyramid-MLM regulations.[157]

Federal legislation would also solve the many inherent disadvantages of non-legislative regulations. In contrast to the DSA and MLMIA measures, a federal statute would require, not merely request, notification of MLM companies that intend to do business in the United States. The enforcement deficiencies that exist in all non-legislative regulations would be eliminated by Congress' authority to impose civil and criminal sanctions.

In 1973, the rise in pyramid schemes prompted then-Senator Walter Mondale to propose a federal bill to prohibit pyramid sales transactions.[158] At the hearings, Mondale described the bill as "one of the most important consumer protection measures currently before the Senate," and described pyramids as an "outrageous, indefensible, cruel and widespread practice in America today."[159] Mondale also stated that the SEC's estimates of pyramid schemes taking approximately $300 million a year from Americans was "a very conservative estimate."[160] Warren Spannaus, then Attorney General of Minnesota, described pyramids

[157] Walter Mondale in his testimony before the Subcommittee for consumers in 1973 stated that "Pyramiders simply flee to States with weak or nonexistent legislation." Pyramid Sales, Hearings Before the Subcommittee on Commerce, 93rd Cong. 2d Sees. 16 (1974) [hereinafter Hearings].

[158] S. 1939. 93rd Cong. Ist Sess. (1973).

[159] Hearings, supra note 89, at 13, 18.

[160] Id. at 17

as the "No. I consumer fraud problem which I have faced in my nearly 4 years as Attorney General of the State of Minnesota."[161] A year earlier, in 1972, Spannaus wrote a letter to Mondale urging the need for federal regulation:

> Each month new pyramid sales and multi-level distribution schemes are developed. Unquestionably, there is a need for uniform Federal legislation which will protect all consumers from the evils of pyramid sales distribution. I consider the need for this legislation to be immediate.[162]

Though the Committee on Commerce reported favorably on the bill,[163] it eventually died on the Senate floor without fanfare.[164] While federal legislation of pyramids may be a good idea, the Mondale proposal was prohibitory in nature and did not really show the sophistication of a bill that would recognize and allow legitimate MLM companies to exist. The bill defined an illegal pyramid scheme as follows:

> any plan or operation for the sales or distribution of goods, services, or other property which contains any provision for increasing participation in the plan through a chain process, whereby a participant pays a valuable consideration for the right, privilege, license, chance or opportunity –
>
> (A) to receive compensation for introducing one or more additional persons into participation in the plan, each of whom receives the same or similar right, privilege, license, chance, or opportunity; or
>
> (B) to receive compensation when a person introduced by the participant introduces one or more additional persons

[161] Id. at 19

[162] Cong. Rec. 16189 (daily ed. Sept. 28, 1972).

[163] S. Rep. No. 93-1114, 93d Cong., 2d Sess. 1 (1974).

[164] C.C.H. Congressional Index, 93d Cong. 2d Sess. 2531 (1974) .

into participation in the plan, each of whom receives the same or similar right, privilege, license, chance, or opportunity.[165]

The bill primarily addresses the payment of a headhunting fee as the essential characteristic of a pyramid: "the receipt of compensation for introducing one or more additional persons into participation in the plan." It does not, however, address any of the problems that the Massachusetts statute addresses such as the inventory loading, lack of retail sales, and the implication made to prospective distributors that a fast buck can be made. The 1973 bill is not sophisticated enough to address problems in an industry that is doing an estimated $20 billion in annual sales.[166]

A preemptive federal statute that closely resembled the Massachusetts statute would represent the optimum regulation of MLM companies. The ideal federal statute would define MLM in a broad way so as to include any marketing system in which participants in the marketing program may recruit other participants and the company grows in a geometric fashion. Like the Massachusetts statute it should contain the following provisions:

(1) the opportunity for the distributor to cancel his contract with the MLM company and for the company to repurchase any

[165] S 1939, supra note 152.

[166] Poe, supra note 72, at 74.

product at at least 90% of the original cost;[167]

(2) that retail sales should be a condition precedent to a distributor receiving bonuses;

(3) that the payment for the mere recruitment of other distributors should be made unlawful (no headhunting fee);

(4) that MLM companies should be prohibited from making claims of expected earnings unless the company substantiate them with statistical evidence of what the average distributor is earning;

(5) that annual notice with the United States Attorney General should be mandatory; and

(6) any violation of the provisions shall constitute an unlawful pyramid scheme.

In addition to the above provisions from the Massachusetts statute, several more might be helpful. MLM companies should be required to post a $100,000 bond or possess $100,000 worth of liability insurance.[168] This policy would be used to provide distributors with a source of relief while not overburdening MLM companies. MLM companies would not be financially dissuaded from entering the industry with such a low bond requirement–a problem that might well occur if multiple state bond or insurance

[167] A 90-day limit on the return of product might make the provision more reasonable from the MLM company perspective.

[168] The size of the bond might also be made dependent on the amount of business a particular MLM company is doing. It does not seem that a $100,000 bond is too large for most new companies to post while at the same time offering the distributors some needed protection.

requirements were imposed by states.[169]

A combination of enforcement remedies would be included in the ideal federal statute. Any MLM company violating the guidelines would be deemed illegal and thus a pyramid. Allowing the state[170] as well as federal authorities either to bring criminal actions or to seek injunctive relief against a pyramid, along with allowing the aggrieved person to recover double damages plus costs and legal fees would afford a variety of procedures necessary to protect the consuming public. The injunctive relief provisions are important since many pyramid sales operations deluge a state with a quick, massive sales attack. Unless states or federal officials can gain immediate injunctive relief, consumers are more likely to be defrauded of millions of dollars before the plan can be prohibited from operating in that region.[171] Since pyramid problems often start off regionally, states should retain the right to enforce the federal statute themselves. A fine could be set at not more than $50,000 or imprisonment for not more than five years for any MLM company officials who violate the provisions of the statute.

A statutory provision should expressly preempt, and thereby invalidate, state regulations. Such a preemption would clear the regulatory field of confusing, burdensome and potentially

[169] Currently only Georgia requires the posting of a bond.

[170] Phone interview with John Brown, attorney with the Amway Corporation (March 1991).

[171] Hull, supra note 147, at 477.

inconsistent state measures. Express preemption would make it clear to MLM companies and distributors that MLM companies can and must operate under one regulatory umbrella only.

If this type of legislation were enacted and the abuses that pyramids practice were eliminated, MLM companies might be seen as innovative marketers making a strong contribution to the economy and providing a bona fide opportunity for interested individuals in that kind of work. A parallel can be drawn between the phenomenon of MLM and the emergence of chain stores in the 1920s and 1930s.[172] The franchises encountered suspicion, hostility, litigation, and repressive legislation before becoming a well-accepted method of distribution. [173] No one disputes the importance of chain stores as vital distribution points in our economy today.

CONCLUSION

The acceptance of MLM as a legitimate marketing tool is demonstrated by its incredible growth over the past ten years and the fact that many Fortune 500 companies are now using this marketing technique. Unfortunately, the opportunity to make extraordinary amounts of money in MLM attracts some unethical and incompetent people into the industry. These individuals have given the MLM industry a bad name and forced many states to clamp down with various regulatory measures. MLM companies are

[172] Ella, supra note 93, at 393.

[173] Id.

hampered and consumers are not well protected by the burdensome, confusing, inconsistent, and outdated state legislative attempts to address pyramid problems. Non-legislative regulations lack the scope and enforcement power to attack the problem meaningfully.

Preemptive federal legislation is necessary to solve the current regulatory inadequacies and to lend legitimacy to an industry which is plagued by its association with its illegitimate forefathers, the illegal chain letters and pyramid clubs. A federal measure, taking into account the specific nature and needs of the MLM industry, could erase existing jurisdictional ambiguities and substantive regulatory inconsistencies while possessing the necessary enforcement and regulatory power. Such a measure would protect consumers from pyramids and lend stability and growth to the MLM industry, an industry with vast economic potential.