

## **THE PYRAMID SCHEME INDUSTRY:**

### **Examining Some Legal and Economic Aspects of Multi-Level Marketing**

**Douglas M. Brooks  
Robert L. Fitzpatrick  
Bruce Craig**

The announcement on March 12, 2014, that Herbalife Ltd. (NYSE: HLF) had received a Civil Investigative Demand from the Federal Trade Commission caps a twenty-two month period during which persistent questions have been raised concerning the purported business opportunity known as multi-level marketing (MLM). While much of the financial media has recently been focused on the Herbalife story, the problems with MLM are not new, and they are not limited to Herbalife. As we explain in this paper, there are fundamental problems at the core of the MLM business model, and with the efforts of the FTC to regulate the MLM “industry.” The authors of this paper are all members of an international coalition of consumer advocates which, on October 24, 2013, filed a formal petition with the FTC requesting that it investigate the MLM industry and promulgate regulations to protect consumers from unfair and deceptive MLM business opportunities.<sup>1</sup> This paper is intended to build on the Petition and to assist legislators, regulators and interested persons to understand the MLM industry and the need for further action.

Why all the fuss over MLM? Why are Wall Street billionaires fighting very public battles over MLM? Is MLM merely a form of direct, person-to-person selling in which independent distributors can earn money both by selling products directly to consumers or by

---

<sup>1</sup> See <https://pyramidschemealert.org/wp-content/uploads/2014/02/Petition-of-Ad-Hoc-Coalition-Concerning-MLM-Final.pdf> and <https://pyramidschemealert.org/wp-content/uploads/2018/04/Members-of-Ad-Hoc-Coalition-Concerning-MLM.pdf>

recruiting additional distributors, who can in turn recruit additional distributors and so on? Or is MLM the modern incarnation of the age-old pyramid scheme, masquerading as direct selling? Why is it so difficult to assess whether an MLM firm is operating as a pyramid scheme? Why should we care?

While MLM firms are not required to disclose data concerning the income, losses and attrition rates of their distributors, in this paper we have analyzed the data which three of the largest and most important MLM firms have chosen to disclose. Although their disclosures are incomplete, inconsistent and often incomprehensible, we have been able to parse out some revealing data. We conclude that of the MLM distributors who are seeking a business opportunity (excluding those who may arguably have joined just to purchase products), approximately 99% are losing money and most eventually drop out. Meanwhile, approximately 54% of all commissions paid by these MLM firms go to the top 1% of distributors, with that top 1% earning a mean average income of about \$128,000. What should we call a plan in which 99% of participants lose, while 1% earn tremendous rewards? Is it a business opportunity or a pyramid scheme?

Controversies concerning MLM have intensified over the past several years, as illustrated by the following series of events:

- On May 1, 2012, Herbalife, one of the largest publicly traded MLM firms, held an investor conference call during which David Einhorn of the hedge fund Greenlight Capital, asked several questions concerning the percentage of Herbalife's sales "outside the distributor network," i.e., to consumers.<sup>2</sup> While Einhorn made no accusations of

---

<sup>2</sup> See <http://www.businessinsider.com/david-einhorn-herbalife-2012-5> (accessed 2/7/14).

impropriety and did not reveal any investment thesis, short or long, Herbalife shares plunged 20%, apparently in the belief that Mr. Einhorn was shorting Herbalife shares and would publish a detailed analysis supporting his views. Greenlight never did publish any report concerning Herbalife. To date Herbalife has failed to provide any actual data in response to Mr. Einhorn's questions.

- In August of 2012, an independent financial analyst firm, Citron Research, released a report accusing Nu Skin Enterprises, another large, publicly traded MLM firm, of operating an illegal pyramid scheme in China.<sup>3</sup>
- In November of 2012, the U.S. District Court in San Francisco approved a \$55 million class action settlement on behalf of distributors of Quixtar, also known as Amway, the largest and one of the oldest MLM firms.<sup>4</sup> The plaintiffs had alleged that Quixtar/Amway was an illegal endless chain scheme and that high level Quixtar/Amway distributors made deceptive earnings claims and sold overpriced products and business support materials to lower level distributors.
- In December of 2012, William Ackman and his hedge fund, Pershing Square Capital, made a detailed presentation supporting their thesis that Herbalife, one of the largest MLM firms and a publicly traded company, is a pyramid scheme.<sup>5</sup> Mr. Ackman stated that Pershing Square had sold short approximately \$1 Billion worth of Herbalife stock.

---

<sup>3</sup> See [http://www.citronresearch.com/page/2/?search-class=DB\\_CustomSearch\\_Widget-db\\_customsearch\\_widget&widget\\_number=preset-default&cs-stock\\_ticker-0=NUS&cs-all-1&search=Search](http://www.citronresearch.com/page/2/?search-class=DB_CustomSearch_Widget-db_customsearch_widget&widget_number=preset-default&cs-stock_ticker-0=NUS&cs-all-1&search=Search) (accessed 2/4/14).

<sup>4</sup> See <https://quixtarclass.com/Home.aspx> (accessed 2/14/14).

<sup>5</sup> See <http://factsaboutheralife.com/> (accessed 2/4/2014).

Other investors have come out in support of Herbalife, including Carl Icahn, George Soros, Daniel Loeb and Bill Stiritz.<sup>6</sup>

- In January of 2013, the Federal Trade Commission (FTC), working with regulators in the states of Kentucky, North Carolina and Illinois, shut down an MLM firm called Fortune Hi-Tech Marketing, alleging that it was a pyramid scheme and that promoters made deceptive earnings claims.<sup>7</sup>
- In April of 2013 Herbalife distributor Dana Bostick filed a class action in the U.S. District Court for the Central District of California (Los Angeles), alleging that Herbalife was violating the California Endless Chain Scheme Law and other claims. The court denied Herbalife's motion to dismiss in October.<sup>8</sup>
- In May of 2013, the CEO of Amway India was arrested for fraud in the Indian state of Kerala.<sup>9</sup> This was only the latest in a series of legal proceedings involving Amway's subsidiary in India.
- In June of 2013, Representative Linda Sanchez (D.Calif.) sent a letter to the FTC requesting that it investigate allegations that Herbalife is a pyramid scheme that is harming consumers, including low-income Hispanics and African Americans.<sup>10</sup>
- In July of 2013, a group of Hispanic and consumer organizations met with the FTC to request an investigation of Herbalife, arguing that Herbalife was targeting deceptive earnings claims at poor, Hispanic would-be entrepreneurs.<sup>11</sup>

---

<sup>6</sup> See <http://www.businessinsider.com/bill-ackman-herbalife-short-anniversary-2013-12> (providing time

<sup>7</sup> See <http://www.ftc.gov/news-events/press-releases/2013/01/ftc-action-leads-court-halt-alleged-pyramid-scheme> (accessed 2/7/14).

<sup>8</sup> See <http://ftalphaville.ft.com/files/2013/10/Bostick-Order-Denying-Motion-to-Dismiss.pdf> (accessed 2/14/14).

<sup>9</sup> See <http://www.theverge.com/2013/6/28/4472608/the-indian-express-pyramid-scheme-investigations-amway-herbalife> (accessed 2/7/14).

<sup>10</sup> See <http://nypost.com/2013/06/13/congresswoman-asks-ftc-to-probe-herbalife/> (accessed 2/14/14).

- In October of 2013 an international coalition of consumer advocates filed a formal petition with the Federal Trade Commission, urging that that the FTC investigate the entire MLM industry and promulgate a trade regulation rule to protect consumers.<sup>12</sup>
- On January 16, 2014, Chinese regulators announced that they were investigating allegations in the Chinese People's Daily that Nu Skin was operating an illegal pyramid scheme in China.<sup>13</sup> Shares in Nu Skin dropped 40% over several days; shares in Herbalife and Usana, another publicly traded MLM with operations in China, also dropped sharply, despite the absence of any evidence that Chinese regulators were investigating them.
- On January 22, 2014, Senator Edward J. Markey (D. Mass.) requested the FTC and the Securities and Exchange Commission to investigate the business practices of Herbalife.<sup>14</sup>
- On January 28, 2014, the New York Post reported that the Canadian Competition Bureau was investigating allegations that Herbalife was operating a pyramid scheme in Canada.<sup>15</sup>
- On January 29, 2014, Representative Linda Sanchez (D. Calif.) held a briefing for other lawmakers concerning pyramid schemes.<sup>16</sup>
- On February 5, 2014, Hispanic consumer groups met with Edith Ramirez, chair of the FTC, concerning Herbalife.

---

<sup>11</sup> See <http://articles.latimes.com/2013/jul/19/business/la-fi-herbalife-latino-20130719> (accessed 2/7/14).

<sup>12</sup> See <http://ftalphaville.ft.com/2013/10/24/1676802/the-ftc-is-standing-in-a-shrinking-circle-of-grey/> (accessed 2/7/14). The authors of this white paper are among the signatories to this petition.

See <http://online.wsj.com/news/articles/SB10001424052702303465004579323840382392148> (accessed 2/7/14).

See <http://nypost.com/2014/01/23/senator-delves-deeper-into-herbalifes-business-practices/> (accessed 2/7/14).

<sup>16</sup> See <http://nypost.com/2014/01/28/canadian-regulator-probing-herbalife/> (accessed 2/7/14).

See <http://nypost.com/2014/01/30/pyramid-scheme-talk-in-the-house/> (accessed 2/14/14).

- On February 18, 2014, the government of India announced that an Inter-Ministerial Group was investigating the functioning of MLM and evaluating the regulatory framework for MLM companies.<sup>17</sup>
- On March 12, 2014, Herbalife announced that it had received a Civil Investigative Demand (CID) from the FTC.<sup>18</sup>

We can answer some of the questions concerning MLM by examining two critical issues:

1. What are the economic consequences for participants in MLM programs? Does MLM actually offer a viable business opportunity to millions of participants? Why do so many MLM participants lose their investments and drop out, while a tiny few gain tremendous
2. Is the basic business proposition of MLM, as it is generally practiced, legal in America? Should an endless entrepreneurial chain *ever* be legal, whether presented as a financial investment or as a “business opportunity,” where the promise of lucrative returns is funded primarily by contributions from future investors? What is the significance of retail sales to

In the first part of this paper we examine the economics of MLM from the point of view of distributors. Specifically, we examine publicly available information concerning three of the largest and most significant MLM programs, Amway, Herbalife and Nu Skin. While these companies do not release all of the relevant data, and the data they do release is presented in a fashion that seems designed to obfuscate and confuse, we are able to demonstrate that the vast majority of MLM distributorships fail, while a tiny few earn tremendous rewards. The dismal financial performance of the MLM business opportunity raises the compelling question: is it legal?

---

<sup>17</sup> See [http://www.business-standard.com/article/pti-stories/high-level-img-looking-into-functioning-of-mlm-nbfc-cis-114021800886\\_1.html](http://www.business-standard.com/article/pti-stories/high-level-img-looking-into-functioning-of-mlm-nbfc-cis-114021800886_1.html) (accessed 2/24/14).

<sup>18</sup> See <http://online.wsj.com/news/articles/SB10001424052702303730804579435303342418222?mod=djemaler+MARKET>

In the second part we examine the legality of MLM, primarily through a series of Federal Trade Commission (FTC) cases beginning in the 1970's. We conclude that the two seminal FTC cases from the 1970's, Koscot and Amway, present two fundamentally different regulatory approaches to MLM. Both cases assert that for an MLM to be legal the rewards to participants must be based on retail sales. In the Koscot approach the retail sales determination is based on two "bright line" requirements: First, the rewards must be based on "actually consummated" retail sales. Second, retail sales are rigorously defined as sales to persons who are not participants in the MLM plan and who are not purchasing in order to participate. In contrast, the Amway approach permits rewards to be based on distributor *purchases*, with the understanding that those purchases should theoretically result in retail sales *in the future* due to the action of various rules originally adopted by Amway (the 10 customer rule, the 70% rule and the buyback rule, collectively referred to as the "Amway rules") that are supposed to encourage retail sales by distributors. In addition, the Amway model has permitted MLM firms to argue that rewards may be paid on purchases by participants so long as they are purchasing for their own use, thus obscuring the distinction between MLM participant and retail purchaser.

The Amway decision purported to follow Koscot, and the FTC has cited Koscot in every one of its pyramid scheme prosecutions to this day. However, the practical effect of Amway was to provide MLM firms with an alternative model for compliance that completely undercuts the rationale of Koscot. Under the Koscot model, the bright line rules would enable regulators, MLM firms, investors and prospective distributors to determine whether a particular MLM plan is legal, based solely on examining the MLM compensation plan itself. Under the Amway model, however, the legality of an MLM plan can only be determined by an after-the-fact analysis of whether retail sales are actually taking place. Such an analysis requires a complex,

factually intensive investigation that can only be done after the MLM program has been up and running for a time, during which substantial, unrecoverable losses to participants will inevitably occur.

MLM firms have overwhelmingly adopted the Amway model and have incorporated the Amway rules into their distributor contracts. We are not aware of any modern MLM that limits the payment of compensation to consummated retail sales. Moreover, most MLM firms have taken the position that compensation may be paid based on purchases by distributors who are buying for their own use (“internal consumption”), despite substantial FTC and federal court case law to the contrary. Compounding the problem is the fact that MLM firms generally do not collect retail sales data from their distributors. For example, Herbalife, one of the MLM firms discussed in this paper, requires its distributors to maintain retail sales records for two years, and to produce those records to Herbalife on request. But despite repeated questions concerning the extent of retail sales in its network, Herbalife maintains that it does not have “visibility” into this data, which indicates that it has chosen not to collect it.

Based on the tremendous loss rates experienced by MLM distributors, we conclude that the Amway model is a failure. Simply put, the Amway rules do not effectively ensure that compensation to MLM participants is based primarily on retail sales, and have not prevented the substantial losses incurred by 99% of MLM participants. Effective consumer protection can be achieved by returning to a rigorous enforcement of the Koscot approach. Koscot properly recognizes the *inherent* fraudulence of the “endless chain” and permits MLM firms to operate only if their compensation plan does not require any purchase to participate and does not permit the payment of compensation other than on consummated retail sales. Alternatively, if the Amway approach is to be permitted, MLM firms must be required to provide evidence, in the

form of distributor retail sales records, that their products are profitably sold on a retail basis to *bona fide* consumers who are not participants in the sales chain.

In addition to ensuring that they are not operating as pyramid schemes, MLM companies must be prevented from making, or allowing their distributors to make, deceptive earnings claims. In the short term this can be accomplished by enforcement actions by the FTC and state regulators, utilizing established precedents for assessing deceptive claims. But enforcement actions are costly and inefficient in protecting consumers from loss. There is no reason why MLM business opportunities should not be subject to pre-sale disclosures similar to those applicable to franchises and other types of business opportunities under the FTC's Franchise Rule and Business Opportunity Rule.

After a brief description of the MLM industry we will address the economics of MLM distributorships, and then examine the legal issues raised by the MLM controversy, and, finally, propose a way out of the morass.

### **What is Multi-Level Marketing?**

The subject of this paper is a form of direct selling known as “multi-level marketing,” popularly known as “MLM.”<sup>19</sup> The Direct Selling Association (“DSA”), which is the primary MLM industry trade association and lobbying group, states that “[d]irect selling is the sale of a consumer product or service, person-to-person, away from a fixed retail location, marketed through independent sales representatives who are sometimes also referred to as consultants, distributors or other titles.”<sup>20</sup>

---

<sup>19</sup> The term “network marketing” is also used to refer to MLM.  
<sup>20</sup> See <http://www.directselling411.com/> (accessed 2/4/2014).

While the origins of MLM can be traced back to the 1950's or before, most of the modern MLM "industry" has developed since 1979, when the Amway decision discussed below provided a template for would-be MLM entrepreneurs to follow and, at least facially, distinguish themselves from pyramid schemes.<sup>21</sup> Today, MLM enterprises are soliciting investments from virtually every household in America.

Reliable data concerning the MLM industry is hard to come by, but it is undeniably a large industry affecting tens of millions of consumers who are induced to purchase billions of dollars worth of products and services, ostensibly to resell as MLM distributors. The DSA estimates that in 2012, total sales of the industry were \$31.63 billion, and the total number of MLM distributors was 15.9 million.<sup>22</sup> The DSA currently has 167 member companies.<sup>23</sup> In 2001 an industry expert estimated that there were over 1,000 MLM firms in the United States.<sup>24</sup> About a dozen MLM firms are publicly traded in the United States, with a combined market capitalization of over \$30 billion.<sup>25</sup>

---

<sup>21</sup> See generally Keep, William and Peter Vander Nat, "Multilevel Marketing and Pyramid Schemes in the United States: An Historical Analysis" *Journal of Historical Research in Marketing*, Vol 6, Issue 4 (November), 2014 (forthcoming), available at [http://business.pages.tcnj.edu/files/2014/02/Keep-and-Vander-Nat\\_MLM-and-Pyramid-Schemes\\_Final.pdf](http://business.pages.tcnj.edu/files/2014/02/Keep-and-Vander-Nat_MLM-and-Pyramid-Schemes_Final.pdf)

<sup>22</sup> See <http://www.dsa.org/research/industry-statistics/> (accessed 2/22/14). The term "direct selling" refers to the sale of a consumer product or service, person-to-person, away from a fixed retail location. All MLM programs involve direct selling; however, not all direct selling companies utilize MLM compensation plans. The DSA reports that approximately 95% of its members utilize an MLM type of compensation plan. See <http://www.dsa.org/research/industry-statistics/11gofactsheet.pdf> (accessed 2/22/14).

<sup>24</sup> See <http://www.dsa.org/forms/CompanyFormPublicMembers/search?action=find> (accessed 2/22/14).

See Zig Ziglar; John P Hayes, PhD (2001), *Network Marketing for Dummies*. Another source lists over three thousand MLM firms, many of which are apparently defunct. See <http://www.financialindustryscam.com/mlm.htm>

<sup>25</sup> Publicly traded MLM firms, and their approximate market capitalizations include Avon (AVP, \$6.6 billion); Herbalife (HLF, \$6.8 billion); Nu Skin (NUS, \$5.1 billion); Tupperware (TUP, \$3.9 billion); Primerica (PRI, \$2.4 billion); Oriflame (ORFLY, \$1.4 billion); Usana (USNA, \$1 billion); Medifast (MED, \$371.1 million); Nature's Sunshine (NATR, \$254 million); Lifevantage Corp. (LFVN, \$140.3 million); Blyth, Inc. (BTH, \$150.2 million); Mannatech (MTEX, \$52.5 million); Natural Health Trends Corp. (NHTC, \$49.3 million); Reliv' Int'l (RELV, \$28.1 million); and Forever Green (FVRG, \$27 million). Of the companies on this list, at least two (MED and BTH) distribute through multiple channels

## Does MLM Offer a Viable Business Opportunity?

Underlying the legal questions that this paper addresses is the fundamental issue of the *economic viability* of the MLM “business opportunity.” The court cases that have been brought against various MLM companies by the FTC, SEC, state Attorneys General and by consumers in class action lawsuits are all founded on the premise that those MLM companies gained their revenues by means of an *inherently unfair and deceptive practice* which caused financial harm to 90-99% of all who invested.

In this section we directly address the *economic realities* that underpin the legal debate and serve as the factual evidence. We do this by offering an analysis of hard data on the actual distributor payouts by three of the largest, oldest and most representative of MLM companies operating in America: Amway, Herbalife and NuSkin. Analysis of this data indicate that at year-end 2012, 1.4 million Americans were enrolled as participants in these three companies. Based on data from the Direct Selling Association, this indicates that these three companies represented approximately 10% of the entire MLM industry in America in 2012.<sup>26</sup>

Not only do these three companies constitute a significant share of the entire industry but they have spawned many imitators selling similar products, using the same model. The inner circles of MLM firms Usana and MonaVie, for example, include a former Nu Skin distributor.<sup>27</sup>

Omnitrition, which became the target of a landmark class action lawsuit, was organized by

---

including MLM, and one (ORFLY) does not distribute in the U.S. Prominent, privately held MLM firms include Amway, Mary Kay, Melaleuca, Monavie, ACN, Shaklee, Sunrider, Pre-Paid Legal, Neways, Market America, Advocare, Arbonne, Xango, Nikken, and Vemma Nutrition Company.

The Direct Selling Association claims that about 15 million Americans are enrolled as MLM distributors. See <https://www.dsa.org/research/industry-statistics/> (accessed 2/20/14).

“Behind the rise of MonaVie is Idaho native Dallin Larsen, the co-founder, chairman and CEO who got his start in multilevel marketing as a distributor for Nu Skin Enterprises, the multilevel marketer of skin-care and nutritional products.” See <http://www.sltrib.com/sltrib/cougars/53061545-79/monavie-company-distributors-percent.html.csp?page=4>. Beginning in 1993, Dallin A. Larsen served as USANA’s vice president of sales (and later as consultant to USANA’s president and special advisor to the board of directors). See <http://en.wikipedia.org/wiki/Usana>

former Herbalife distributors. The largest MLM based in Mexico, Omnilife, which sells essentially the same types of products that Herbalife does, is owned by a former Herbalife distributor.<sup>28</sup> The MLM companies organized by individuals formerly associated with Amway are too numerous to list. Amway, Nu Skin and Herbalife are the archetypes of MLM in America. The financial outcome of their income propositions to 1.4 million Americans are seminal and representative of the entire industry in America.

MLM spread like wildfire following the FTC's Amway decision in 1979. Herbalife was founded in 1980, almost immediately after the Amway decision.<sup>29</sup> Nuskin, was launched a few years later by several individuals that had been top recruiters for another MLM, Cambridge Diet Plan, which had gone bankrupt.<sup>30</sup>

Though retail sales levels and the percentage of consumer-investors earning net profits serve as the primary criteria of MLM legality, MLMs are not *required* to provide the data on these indicators to regulators. Indeed, MLM companies have become veritable “black boxes” in which the necessary financial data are not disclosed to consumers or to investors for due diligence purposes. The companies themselves often claim they do not have data concerning retail sales or the profitability of their distributors, the critical information on which, according to the Amway ruling, their very legality rests. This report seeks to shine a useful light on these questions by offering the hard data with analysis on the three icons of MLM in America.

---

<sup>28</sup> See <http://en.wikipedia.org/wiki/Omnilife>.

<sup>29</sup> See <http://company.herbalife.com/our-history/our-founder> (accessed 2/20/14).

<sup>30</sup> See <http://www.deseretnews.com/article/176126/NU-SKIN-BRINGS-IN-THE-BIG-BUCKS-FOR-WYOMING-NATIVE.html?pg=all> (accessed 2/20/14).

### **Where did we get the data?**

Data concerning these three companies were obtained from three main sources. First, each of these companies publishes income “disclosures” on their respective websites.<sup>31</sup> Second, each of the two publicly traded companies studied, Herbalife and Nu Skin, provide some data relevant to distributor revenues in their securities filings. For Amway, which is not publicly traded, we obtained data from Amway’s public statements in addition to published income disclosures.<sup>32</sup>

There are no uniform standards governing how MLM distributor income data is presented, and each company is selective in what data it chooses to report and how it is reported. Even presumably basic data such as the total number of distributors is not reported in a straightforward, comprehensible fashion, forcing us to undertake a series of calculations in order to get the number. For instance, some of the companies only report incomes for distributors who are characterized as “active” or “sales leaders.” They then state what percent of the total that the “actives” constituted, without disclosing the total. In some cases, such as Nuskin, the company states the percentage of “actives” that received a payment and then the percentage of the total that comprises the “actives.” Only if a consumer were to put the two calculations together would they learn that 95% of all Nuskin distributors receive no payment.

---

<sup>31</sup>

Each of the companies studied have followed the practice of preparing official income disclosures and posting them on their respective websites. Copies of each company’s statement for the year 2012 were downloaded and are [available here](#).

<sup>32</sup> Some data concerning Amway distributor revenues was obtained from a February 15, 2012 Wall Street Journal article. See <http://online.wsj.com/news/articles/SB10001424052970204062704577223302734609434?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424052970204062704577223302734609434.html> Additional data was obtained from an Amway advertising campaign launched in September of 2013. See <http://news.amway.com/2013-09-05-Amway-Touts-A-Cure-For-Common-Cubicle-In-National-Ad-Campaign>

Once a hard number was determined for the total number of distributors in the USA, then the disclosed percentages of distributors in each level of the company's marketing plan were also converted to hard numbers. When that hard number, per level, was multiplied by the disclosed mean average payments for each level, then the aggregate payout to each level was determined. When each level's total payout was determined, they were summed up and then the percentage of the total that each level received was revealed. The same was done for the number of distributors in each level. A sum was made and then the percentage of the total that each level constituted was calculated.

Total USA sales are found in 10K filings or in public statements by company officials. With that number and the total number of distributors, an average purchase per distributor was calculated, and from that figure an *estimate* of maximum retail profit was made, based on a generous estimate of 30% retail profit margin on retail sales (30% gross retail profit is equivalent to a 43% markup on the wholesale purchase price).

### **Difficulties with the Data**

The "income disclosures" by the MLM companies referenced in this report contain statistical calculations that skew or distort the presentation and in some cases are outside normal rules of math. However, they are used for this analysis since these are the only data available to consumers or investors. For example:

- The "total" number of distributors is typically presented as a static number counted at the end of a year. This is incomplete, since distributors may join and drop out during the course of the year. None of the companies in this analysis revealed the full cumulative number of distributors that had been under contract *at any time during the entire year*.

- Though a static year-end number is used to calculate “total” distributors, *all* purchases made by each and every distributor that enrolled *at any time during the year* are counted in total revenue, and commissions are paid on all purchases, cumulatively during the year. This omission has the effect of inflating the reported “average” income figures.
- None of the companies currently discloses the attrition rate for MLM participants. The DSA states that “[d]uring 2001-2003, the average annual turnover rate of direct sellers was 56%.”<sup>33</sup> Given that the membership of the DSA is overwhelming comprised of MLM companies, it is reasonable to believe that this is representative of the MLM industry. Similarly, in its 2005 Form 10K Herbalife reported that for the twelve month period ending in January 2005 (the most recent filing in which Herbalife provided this data) “approximately 60 percent of our supervisors did not re-qualify and more than 90% of our distributors that are not supervisors turned over.” This translates to an overall annual attrition rate of 80%. As noted above, by not revealing the turnover rate in the disclosures, the total number of distributors is reduced and the mean average incomes are therefore *increased*.
- Several of the companies present monthly averages paid to each level, that is, the total amount paid to those in that level divided by those who reached the level in the month. But this number is then “annualized” to portray an “average annual income.” The annual figures, which this Paper reports, are only a representative data point, not an actual average. Due to the high attrition rates, the individuals participating in any given month are not necessarily the same ones enrolled in previous or subsequent months. It is deceptive for MLM companies to “annualize” the months to portray an “average annual income.” The “annualized” figure is not an actual annual average for an individual distributor. It is a multiple of monthly averages. The only

---

<sup>33</sup> See <http://www.directselling411.com/glossary-and-faq/industry-faq/> (accessed 2/20/14). The DSA has not published more recent attrition statistics.

distributors likely to earn an “annual” income of any amount are the tiny few at the peak of the pyramid who likely remain in their top positions throughout the year and from year to year. All the others, on average, join and quit at a rate of 40-90% per year.

- The average incomes for USA distributors at the top of the chain include overrides gained *globally*, not just from 99.5% of other distributors *in the USA*. This factor skews the average incomes of the top 1% *upward* and likely increases the total who are in the upper levels as well. The actual percentage in the upper levels *regionally* would be smaller and the income averages would likely be less than those in this report of USA distributors.
- None of the “income” data refers to “profits”. Actual *costs* of participating in a MLM business can be substantial, especially for those in the upper levels who travel in order to replenish the ranks of their churning recruits. If costs of purchases (purchasing is incentivized to succeed in the pay plan) are counted as a business cost, on average, more than 99% do not make a net profit.<sup>34</sup>

#### **What can we conclude from the data?**

- **Representative of Entire Industry:** Relying on national data provided by the Direct Selling Association and on the validity of data from Amway, a private company, the three companies, Herbalife, Amway and NuSkin, combined, constitute 10% of the entire MLM industry in the USA, 1.4 million distributors (households).
- **Only the Top ½ of 1% Receive *Livelihood Income Levels*:** Of the 1.4 million Americans who were enrolled as distributors with these three companies in 2012, only about

---

<sup>34</sup>

In a prosecution of Amway by the State of Wisconsin, analysis of the tax returns of Amway distributors indicated that during the two year period 1979-80, the average Amway “Direct Distributorship” (which collectively comprised the top 1% of all Amway distributors in Wisconsin) had adjusted gross annual income of \$14,389 but after deduction of business expenses incurred a net loss of \$918. See Complaint in State of Wisconsin v. Amway Corp., et al. No. 589806 (Milwaukee Circuit Court, July 28, 1982). A copy of the Complaint is reproduced in Kerns, Phil, Fake it Til You Make It! (Victory Press 1982), pp. 134-46.

5,500 received, on average, what might be considered a livelihood, that is, gross income above \$60,000 per year. The incomes of sectors of the MLM sales forces of the three companies analyzed are disclosed in ranges. Distributors in the highest range, which includes those with incomes above \$50-60,000 per year, earned mean average incomes above \$120,000. Actual net income of this group is unknown since costs are not disclosed. It is generally understood that costs rise significantly as do time commitments for those at the highest ends of MLM sales chains, so most of these highest earning distributors earn rather modest incomes. This group constitutes just 0.39% of total distributors, or about 1 in 250.

- **Only 1% of the Upper Sector of the Chain – Seeking Income – Gain Livelihood Income/Average. All others, on Average Show Net Losses:** The “leader” and “active” sector – as defined by the companies themselves - comprise the upper 37% of the combined USA sales forces of the three companies. From that upper group, the majority of which are manifestly seeking “income” as distributors, not just “discounted” consumer products, only about 1% earn “livelihood” incomes, before costs are deducted.
- **Purchases Exceed Incomes on Average:** The mean average income for the bottom 99% of the “leaders” and “active” participants is less than the average *purchases* per distributor for the entire sales channel (total purchases divided by total number of distributors). Average purchases for all distributors of the combined groups is \$1,578 per year while the mean average income for the lower 99% of “leaders” and “actives” is \$1,164. Presumably, the upper sector purchases more than the overall average, but none of the companies reveal average purchase volumes per level.
- **Downline Purchases, which Serve as the Basis for Upline Incomes Are Incentivized:** All three companies offer financial incentives for distributors to *buy* products and all have quotas

and threshold incentives offering higher rewards based on total volume that includes personal *purchases*. Moreover, all commissions are based on the *purchases*, not sales, of the chain, including one's own purchases. Purchasing products is an integral aspect of the pay plan and cannot be divorced from the incentives, rewards and restrictions.

- **Concentrated Money Transfer:** All three companies use complex, virtually indecipherable pay formulas that result in the transfer the majority of commission on *all aggregate sales* to the top 1%. In aggregate, 54% of all commissions paid *on all sales* were transferred to the top 1%, making average profit to the bottom 99% virtually impossible. In actual dollar figures for the top 37%, the “active/leader “sector, 99% of that group has a mean average gross income (before costs) of \$22.38 a week in commissions. The top 1% tier of that sector averaged \$128,643 per year.

- **No Retail Sales Profit:** Based on average purchase levels, (total USA annual revenue divided by total number of USA salespeople) the maximum *gross retail profit* available to all distributors on average is about \$13 a week, before all selling costs, and assuming that 100% products are sold at suggested retail prices, which is exceedingly unrealistic. This is estimated by assigning a projected 30% retail profit on purchases. The actual retail profits earned by distributors, if any, would be less, to allow for sales below suggested retail price, the use of products for samples or self-consumption. *The data indicate there is no viable retail sales income opportunity.*

- **No Evidence of Significant Retail Sales:** No data is available that show any significant retail sales activity, indicating that the income of the top 1% is sourced primarily from the internal inventory purchases of the bottom 99% whom they recruited in a closed market without an external retail sales revenue source.

- **Churn/Attrition:** The data does not reflect the attrition and recruitment of distributors during the course of the year. This data is not provided by any of these companies. Using typical MLM industry experience of 50–80% annual turnover among distributors, average incomes would be much lower.
- **Saturation:** All three companies compete with each other for recruits and all sell beauty and diet products. Aggregate data on the total number of distributors for these three companies show only about 100 households per salesperson left in America to sell to or recruit (fewer households if attrition is taken into account).<sup>35</sup> Market saturation has been reached for the vast majority of existing distributors.

---

<sup>35</sup> Current data on total households shows 115 million households in the U.S. See

## Summary of Disclosures and Analysis\*

Companies	Top 1% (approx.) of Actives and Leaders <ul style="list-style-type: none"> <li>Total Number</li> <li>% of Entire Chain</li> <li>Average Income</li> </ul>	<ul style="list-style-type: none"> <li>Total Payout to the Top 1% of Actives</li> <li>% of Total Commissions Paid to Top 1% of Actives</li> </ul>	Average Income of 99% "Active" or "Leader" Distributors Below the Top 1% <ul style="list-style-type: none"> <li>Annual</li> <li>Weekly</li> </ul>	Number of "Active" or "Leader" Distributors Below the Top 1%	Total Payout to All "Active" or "Leader" Distributors Below the Top Tier	Total Payout to All "Active" or "Leader" Distributors	All Distributors USA 2012	Total Revenue USA 2012	Average Annual Purchases per Distributor
Amway	<ul style="list-style-type: none"> <li>3,345 (.97%)</li> <li>0.42% of entire sales chain</li> <li>\$108,675 av. income p. yr.</li> </ul>	<ul style="list-style-type: none"> <li>\$363,520,214</li> <li>44%</li> </ul>	<ul style="list-style-type: none"> <li>\$1,375 per year</li> <li>\$26.44 p. wk.</li> </ul>	338,655	\$465,487,786	\$829,008,000	743,500	\$1.2 Bil	\$1,614
Nu Skin	<ul style="list-style-type: none"> <li>997 (1.29%)</li> <li>0.5% of entire sales chain</li> <li>\$103,030 av. income p. yr.</li> </ul>	<ul style="list-style-type: none"> <li>\$102,625,644</li> <li>81.7%</li> </ul>	<ul style="list-style-type: none"> <li>300 per year</li> <li>\$5.77 p. wk.</li> </ul>	76,359	\$22,911,626	\$125,537,268	193,826	\$242 Mil	\$1,249
Herbalife	<ul style="list-style-type: none"> <li>1,185 (1.04%)</li> <li>0.24% of entire sales chain</li> <li>\$206,638 av. income p. yr.</li> </ul>	<ul style="list-style-type: none"> <li>\$244,866,604</li> <li>66%</li> </ul>	<ul style="list-style-type: none"> <li>\$1,116 per year</li> <li>\$21.46 p. wk.</li> </ul>	111,900	\$124,936,556	\$369,803,160	493,862	\$816.9 Mil	\$1,654
Total	<ul style="list-style-type: none"> <li>5,527</li> <li>0.39% of entire sales chain</li> <li>\$128,643 av. income p. yr.</li> </ul>	<ul style="list-style-type: none"> <li>\$711,012,462</li> <li>54% of all payouts</li> </ul>	<ul style="list-style-type: none"> <li>\$1,164</li> <li>\$22.38 p. wk.</li> </ul>	526,914	\$613,335,968	\$1,324,348,428	1,431,188	\$2.259 Bil	\$1,578

\* The official income disclosures of Amway, Nu Skin and Herbalife can be viewed at <http://pyramidschemealert.org/income-disclosures-of-herbalife-nu-skin-and-a>

\*\*Maximum Possible Gross Retail Profit, on average, is determined by first factoring the average per capita purchases of \$1,578 (total revenue divided by total number of distributors).

- 30% retail profit on these average purchases equates to a 43% mark-up. Average annual purchases of \$1,578 sold at a 30% retail profit would factor to total retail profit of \$676 per yr., or \$13 per week, per distributor.
- This maximum possible gross profit would require selling all inventory at full retail price, no discounting, no samples, and no self-consumption, which is obviously not realistic.
- The data show, effectively, no retail profit opportunity exists, on average, after costs of time, marketing and sales are deducted and a realistic retail sales volume is used.

## **What does the law say about MLM?**

There is no definition of “pyramid scheme” in any federal statute. Both the Federal Trade Commission and the Securities and Exchange Commission have, through prosecutions and case law, developed their concepts of what constitutes a pyramid scheme. The FTC, following its statutory mandate to protect consumers from “unfair or deceptive acts or practices in trade or commerce,” has developed a definition applicable to MLM programs through a series of cases beginning in the 1970’s. In Koscot the Commission stated that:

Such 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 sale of the product to ultimate users. In general such recruitment is facilitated by

In re Koscot Interplanetary, Inc., 86 F.T.C. 1106, 1180 (1975), aff’d mem. sub nom., Turner v. FTC, 580 F.2d 701 (D.C. Cir. 1978). The Commission continues to cite the Koscot rule in all of its pyramid scheme prosecutions. See, e.g. FTC v. Trudeau, No. 03-C-3904 (N.D.Ill.) (Affidavit of Peter Vander Nat filed Dec. 20, 2013); FTC. v. Burnlounge, Inc., No 12-55926 (9<sup>th</sup> Cir.) (Brief of FTC filed April 1, 2013). The Koscot rule has been followed by the federal courts. U.S. v. Gold Unlimited, 177 F.3d 472, 480-81 (6<sup>th</sup> Cir. 1999); Webster v. Omnitrition International, Inc., 79 F.3d 776, 781-82 (9<sup>th</sup> Cir. 1996).

The Koscot definition contains three key elements: (1) the participant has the right not only to sell products but to recruit other participants into the program, who in turn have the right to recruit still more participants (the “endless chain” element); (2) the right to participate requires a payment of money (the “payment” element); and (3) the recruitment of new participants results in compensation paid to participants which is unrelated to the sale of product to ultimate users (the “retail sales” element).

Most of the current controversy over MLM operations concerns the retail sales element. Before addressing that element, it is worth discussing the first two elements.

### **The Endless Chain Element**

In all of the recent discussions concerning MLM, the “endless chain” aspect has received very little attention. In part this is because with all of the MLM programs at issue, including those addressed here, it is undisputed that the compensation plans contemplate an endless chain of recruitment, in which each new recruit can only achieve success by recruiting more distributors who will themselves recruit still more distributors. In Koscot the FTC expressed in straightforward terms the fundamental deception at the heart of entrepreneurial chains:

Respondents' marketing plan contemplates upon the payment of consideration, participants would thereby acquire the right to engage in two income-producing activities, one of which contemplated the sale of similar rights to others for which substantial compensation would be paid, while the other contemplated the sale of products or services. Since implicit in the holding out of such rights is the representation that substantial rewards would be gained therefrom, and since the operation of such plan due to its very structure precludes the realization of such rewards to most of those who invest therein, such plan is inherently deceptive. Furthermore, such plan is contrary to established public policy in that it is generally considered to be unfair and unlawful and is by its very nature immoral, unethical, oppressive, unscrupulous, and exploitative. Therefore, such plan was and is inherently unfair and the operation of the Koscot marketing plan by respondents, having caused substantial injury to the participants therein as well as to other members of the public, constitutes an unfair and deceptive act and practice and an unfair method of competition in violation of Section 5 of the Federal

In re Koscot, 86 F.T.C. at 1180.

The fundamental deception of such a plan seems obvious, yet the FTC seems to have tacitly decided to permit such plans, provided that they do not require a payment to participate and do not pay compensation except on retail sales, as discussed below. In Koscot the FTC

noted that even if commissions were based on retail sales, this type of plan would inevitably lead to losses when the newest rank of distributors finally ran out of retail customers:

Indeed, even where rewards are based upon sales to consumers, a scheme which represents indiscriminately to all comers that they can recoup their investments by virtue of the product sales of their recruits must end up disappointing those at the bottom who

In re Koscot, 86 F.T.C. at 1180. The Commission continued:

At the very least we would conclude that a company which offers its distributors substantial rewards for recruiting other distributors, and charges them substantial amounts for this right, creates overwhelming barriers to the development of a sound retail distribution network and resultant meaningful retail sales opportunities for participants. What compels the categorical condemnation of entrepreneurial chains under Section 5 is, however, the inevitably deceptive representation (conveyed by their mere existence) that any individual can recoup his or her investment by means of inducing others to invest. That these schemes so often do not allow recovery of investments by means of retail sales either merely points up that there is very little positive value to be lost by not allowing

In re Koscot, 86 F.T.C. at 1180-1181.

It may be too late in the regulatory game to simply prohibit endless entrepreneurial chains regardless of how they are structured. But making the legality of such schemes depend on whether participants are paying for the right to earn compensation on ever expanding waves of recruits, or whether the compensation is being paid on retail sales, is putting lipstick on a pig. Moreover, as discussed below, it invites gamesmanship among MLM firms in designing compensation plans which disguise or obscure the fact that participants must pay up in order to “make real money,” and which distort the meaning of “retail sales” in order to pay compensation based on inventory investments of participants.

## The Payment Element

In Koscot the payment element was defined in Section I.3. of the final order, which prohibited the defendants from:

Requiring or suggesting that a prospective participant or a participant in any merchandising, marketing, or sales promotion program purchase any product or services or pay any other consideration, either to respondents or to any person, in order to participate in said program, *other than payment for the actual cost to respondents*, as determined by generally accepted accounting principles, of those items respondents deem to be reasonably necessary sales materials in order to participate in any manner therein;

86 F.T.C. at 1186. Under this definition, a “starter kit” containing, for example, promotional and sales material and perhaps some product samples, purchased by the MLM distributor from the company at cost, would not be considered a “payment.” However, this exemption expressly did not apply to “product inventory.” Accordingly, any requirement that a distributor purchase inventory should be deemed to be a “payment.”

In Koscot, the marketing plan explicitly required participants to make payments for inventory to advance to various levels in the scheme. 86 F.T.C. at 1179. Accordingly, proof of the “payment” element was easily obtained. In contrast, the FTC found that Amway did not impose such requirements. In re Amway, 93 F.T.C. 618, 715-717 (1979). The MLM industry learned this lesson. Most MLM firms require the purchase of a starter kit of some sort (Herbalife calls it an “International Business Pack”; Nu Skin calls it a “Business Portfolio”; Amway has a “Business Services and Support package”), but the cost is usually nominal, less than \$100 and most MLM companies undoubtedly would be prepared to establish that these items are sold “at cost.” Moreover, at least in sophisticated MLMs like Herbalife, Nu Skin and Amway, the purchase of a starter kit or its equivalent does not result in the payment of a commission to any upline distributor.

Similarly, most modern MLM firms do not have any explicit inventory purchase requirements; in fact most MLM firms state repeatedly that distributors are not “required” to purchase any inventory. A careful examination of how their compensation plans actually operate, however, demonstrates that as a practical matter there most certainly are inventory purchase requirements. The FTC recognized this phenomenon in a Staff Advisory Opinion dated January 14, 2004, signed by James A. Kohm, Acting Director of Marketing Practices (the “Kohm Letter”), which states in relevant part that:

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 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. The most common means employed to achieve this goal is to require a

As discussed above, Herbalife, Nu Skin and Amway all employ variations of the subterfuge identified in the Kohm letter; they all effectively impose product purchase requirements as qualifications for earning commissions based on downline purchases. Accordingly, each of these companies can point to the fact that there are no required purchases to become a distributor. However, in each of these MLM systems, distributors cannot reap the promised benefits unless they purchase a certain volume of products as well as maintain a “group volume.” Does the elimination of purchase requirements at the entry level of distributorship rescue them from satisfying the Koscot “purchase element?” Should an MLM firm be able to evade the purchase element by the simple expedient of creating an entry level distributorship whose only purchase requirement is a starter kit? The only Circuit level appeals court which has considered this issue has answered “no.”

---

<sup>36</sup> See [http://www.mlmwatchdog.com/files/FTC\\_Letter.pdf](http://www.mlmwatchdog.com/files/FTC_Letter.pdf) (accessed 2/28/14). As of the date of this paper the Kohm Letter was not available on the FTC’s web site, but has been widely circulated.

Omnitrition argues that because it does not charge for the right to sell its products at the "distributor" level, as a matter of law the first *Koscot* element is not met. We disagree.

Omnitrition's argument improperly focuses only on the "distributor" level of Omnitrition's program. The program is unquestionably *not* a pyramid scheme if only the distributor level is taken into account; the participant pays no money to Omnitrition, has the right to sell products and has no right to receive compensation for recruiting others into the program. The distributor level, however, is only a small part of the entire program. Taking into account the "supervisor" levels, a reasonable jury could conclude

Webster v. Omnitrition Intern., Inc. 79 F.3d 776, 780-82 (9<sup>th</sup> Cir. 1996).

### **The Retail Sales Element**

As discussed above, the element of the Koscot test which has received the most attention is the payment of compensation unrelated to retail sales. Critically, the final injunction in Koscot provided that (a) compensation could only be paid on "actually consummated" sales, and (b) compensation could only be paid on sales to persons who were not participants in the MLM plan.

The key language from the Koscot injunction prohibited the defendants from:

2. Offering, operating, or participating in, any marketing or sales plan or program wherein a participant is given or promised compensation (1) for inducing another person to become a participant in the plan or program, or (2) when a person induced by the participant induces another person to become a participant in the plan or program; Provided, That the term 'compensation,' as used in this paragraph only, does not mean any payment based on actually consummated sales of goods or services to persons who are not participants in the plan or program and who do not purchase such goods or

86 F.T.C. at 1186. The previously decided Holiday Magic case made a similar distinction:

Paragraph II(1) will not prohibit payment of compensation to distributors for recruiting other distributors based on actually consummated sales of such recruits to consumers. We recognize that some incentive is necessary in a direct selling system in which a company lacks resources to hire distributional personnel, to induce distributors to recruit other distributors. Overrides based on actually consummated retail sales of recruits appear to us to be the least potentially pernicious of such incentives, and not subject to the same abuse

inventory purchases. The order would not forbid such payments to compensate distributors for recruiting efforts, but such an incentive structure should help impress upon all participants that their concern must be with retailing or building a retail

In re Holiday Magic, 84 F.T.C. 748, 1043 (1974).

Neither the FTC nor any federal court has explicitly abandoned these two elements of the retail sales requirement. However, the FTC failed to apply them in the infamous Amway case.

### **The Amway Decision**

The FTC brought a case similar to Koscot against the Amway Corporation in 1975. The Amway case consumed four years of litigation, thirty contested pretrial orders, a lengthy trial before an administrative law judge with over 150 witnesses and over 1,000 exhibits, and a subsequent appeal to the Commission. In re Amway, 93 F.T.C. 618, 630-31 (1979). The Commission ultimately ruled that although Amway was using a pyramid structure, it would not be considered an illegal pyramid because it had adopted, and enforced, certain internal rules which were believed to prevent the problems recited in Koscot.

The Commission's decision cited the Koscot definition, as well as two other pyramid/MLM cases, In re Ger-Ro-Mar, 84 F.T.C. 95 (1974), aff'd in part, rev'd in part sub nom, Ger-Ro-Mar v. F.T.C., 518 F.2d 33 (2d Cir. 1975) and In re Holiday Magic, Inc., 84 F.T.C. 748 (1974). The Commission then distinguished the "Amway Plan" from these cases:

The Koscot, Ger-Ro-Mar, and Holiday Magic cases all involved 'marketing' plans which required a person seeking to become a distributor to pay a large sum of money, either as an entry fee (usually called a 'headhunting' fee) or for the purchase of a large amount of nonreturnable inventory (a practice known as 'inventory loading'). In exchange, the new distributor obtained the right to recruit others who would themselves have to pay a large sum of money--some of which would go to the recruiting distributor--to join the organization. [9]

By contrast, a person is not required to pay a headhunting fee or buy a large amount of

required to make is a \$15.60 Sales Kit, which contains Amway literature and sales aids; no profit is made in the sale of this Kit, and the purchase price may be refunded if the distributor decides to leave the business. Initial Decision, p. 12, Findings 34-37. Thus a sponsoring distributor receives nothing from the mere act of sponsoring. It is only when the newly recruited distributor begins to make wholesale purchases from his sponsor and

93 F.T.C. at 715-16. We are not privy to the evidence which was presented to the Administrative Law Judge and the Commission in Amway over thirty-five years ago, but we note that the findings concerning the initial “Sales Kit” and subsequent wholesale purchases generating commission to the “sponsor” do not justify distinguishing the Amway plan from Koscot and the other pyramid cases. As discussed above in the section on the “purchase element,” it appears that Amway simply employed a more sophisticated structure, which involved an initial, nominal fee to become a distributor and disguised the subsequent payments as inventory purchases. This error, if it was the only one, would not have had any lasting impact on MLM law, but the Commission then took a serious departure from Koscot in dealing with the “retail sales” element:

And Amway has prevented inventory loading at this point with its 'buy-back rule,' which states that a sponsoring distributor shall '[p]urchase back from any of his personally sponsored distributors leaving the business, upon his request, any unused, currently marketable products. . . .' By this rule, a sponsoring distributor is inhibited from pushing unrealistically large amounts of inventory onto his sponsored distributors in order to

Two other Amway rules serve to prevent inventory loading and encourage the sale of Amway products to consumers. The '70 percent rule' provides that '[every] distributor must sell at wholesale and/or retail at least 70% of the total amount of products he bought during a given month in order to receive the Performance Bonus due on all products bought . . . .' This rule prevents the accumulation of inventory at any level. The '10 customer' rule states that '[i]n order to obtain the right to earn Performance Bonuses on the volume of products sold by him to his sponsored distributors during a given month, a sponsoring distributor must make not less than one sale at retail to each of ten different customers that month and produce proof of such sales to his sponsor and Direct

93 F.T.C. at 716. Here is the crux of the problem with the Amway decision: In endorsing these “Amway rules” the Commission failed to enforce the requirement in Koscot that the compensation paid to distributors be based solely on consummated retail sales. Moreover, the Commission did not even seem to recognize that it was changing the rules of the game.

Perhaps the Commission was led astray by the factual finding of the Administrative Law Judge that the Amway rules were effective in ensuring that retail sales were actually being made.

It noted that:

The ALJ found that the buy-back rule, the 70 percent rule, and the ten customer rule are enforced, and that they serve to prevent inventory loading and encourage retailing. Initial Decision, p. 26, Findings 72-75, and p. 58, Findings 145-47. Given these facts, the Amway plan is significantly different from the pyramid plans condemned in Koscot, Ger-Ro-Mar, and Holiday Magic. Specifically, the Amway Plan is not a plan where participants purchase the right to earn profits by recruiting other participants, who

93 F.T.C. at 716-17. Here again we have to question the adequacy of the fact finding process.

There is no indication in the decisions of either the Administrative Law Judge or the Commission that Amway produced actual evidence of retail sales. All that appears in support of this finding is the conclusory testimony of Amway officers and some of its high level distributors. For example, here is finding 75:

75. The buy-back rule, the 70% rule, and the ten-customer rule encourage retail sales to consumers. (Van Andel, Tr. 1999-2000, 2010; Halliday, Tr. 6231-33; Lemier, Tr. 176; Cady, Tr. 5795-97) (27)

93 F.T.C. at 646. And here are findings 145, 146 and 147:

145. Amway’s buy-back rule deters inventory loading by sponsoring distributors. (Van Andel, Tr. 1999-2000; Halliday, Tr. 6231-32; S.Bryant, Tr. 4062-63)

146. Amway’s 70% rule deters inventory loading by sponsoring distributors. (Cady, Tr. 5795-97; Halliday, Tr. 6231; Lemier, Tr. 176)

147. Amway’s ten customer rule deters inventory loading by sponsoring distributors. (Max, Tr. 5996-97)

93 F.T.C. at 668. These are rather thin factual findings on which to premise the critical judgment that Amway was only paying compensation based on actual retail sales. Significantly, however, it was Amway that bore the burden of proof on this issue. Amway, sued as a pyramid, had the burden of proof not only that it had these “retail sales rules” but that they effectively prevented the abuses listed in Koscot and resulted in actual retail sales. See Omnitrition, 79 F.3d at 783; SEC v. International Heritage, Inc., 4 F.Supp.2d 1378, 1384 (N.D.Ga.1998) (“[T]he critical determination of the legality of [defendant's] operations will not be based on the written plan but on the actual practices of the company.”). As the Sixth Circuit has held:

We find it more appropriate, however, that a defendant carry the burden of establishing that it has effective anti-saturation programs. Given the grave risks imposed on investors in illegal schemes, the government should have to do no more than prove that the program satisfies the definition of Koscot.

U.S. v. Gold Unlimited, Inc., 177 F.3d 472, 482 (6<sup>th</sup> Cir.,1999).

30 years of pyramid prosecutions the FTC has taken upon itself the burden of proving, over and over again, the consumer injury inflicted by these schemes. This proof has normally been in the form of expert testimony of FTC economist Peter Vander Nat. For instance, in the recent joint FTC and state attorney general action against Fortune High Tech Marketing, commenced in January 2013, Dr. Vander Nat stated:

In its decade of operation, FHTM has defrauded hundreds of thousands of consumers out of hundreds of millions of dollars. FHTM's victims, including at least 100,000 current participants, live throughout the United States and Canada. The founders of this enterprise, Paul Orberson and Thomas Mills, along with a handful of others, have reaped millions while the overwhelming majority of recruits have lost nearly all of the money

The FTC also stated in its memorandum in support of a temporary restraining order:

FHTM targets its recruitment efforts at consumers who are struggling to make ends meet but have an entrepreneurial bent. Increasingly, FHTM has been recruiting non-native English speaking recruits. In fact, several of the presentations at FHTM' s annual

convention are conducted in Spanish, particular Spanish-speakers as are many local recruiting meetings. FTHM's promises of significant earnings are patently false: more than 90% of consumers who join FHTM earn nothing at all and at least 96% should

F.T.C. v. Fortune Hi Tech Marketing, Inc., No. 13cv578 (N.D.Ill., Eastern Div.).<sup>37</sup>

Given the explicit ruling in the Amway case, it is the defendant who has the burden of proving that its otherwise illegal pyramid scheme is legal, not the burden of the FTC to wait until evidence of victim losses is gathered and documented. This critical legal requirement has been ignored for over 30 years. The prescient language of the Koscot case predicted this unfortunate development.

It is regrettably clear that responsible authorities, including this Commission, have acted far too slowly to protect consumers from the manipulations of respondents and others like them.

86 F.T.C. at 1181.

The Amway decision immediately and dramatically changed the legal landscape of the MLM world. MLM firms were provided with an attractive alternative to complying with the onerous definition of “retail sales” in the Koscot injunction. Instead of limiting compensation to consummated retail sales, MLM firms could pay compensation on *purchases* by downline participants, provided that they followed the “Amway rules.” Every sophisticated MLM firm promptly adopted some variant of the Amway rules. The decision also made billionaires of the Amway owners and funded a highly effective lobby which has successfully insulated endless entrepreneurial chain schemes from effective regulation and meaningful enforcement.

### **Are the Amway Rules Sufficient to Prevent MLM Pyramid Schemes?**

The Amway rules which supposedly encourage retail sales are impotent when faced with the overwhelming incentives of MLM plans to encourage recruiting profits in return for required

---

<sup>37</sup>

Available at <http://www.ftc.gov/sites/default/files/documents/cases/2013/01/130128fthmmotiontro.pdf>

inventory purchases. Aside from the conflict inherent between the incentives of the MLM compensation plan and the encouragement of retail sales, there is a notable absence of data to support the proposition that substantial retail sales are actually taking place. MLM firms have data only as to sales made to their distributors. Any proof of actual retail sales would have to be collected from their “independent” distributors. Because the distributor's status is dependent on the proof of compliance, the potential for inaccurate responses is virtually assured. This is particularly relevant in light of the fact that all available evidence, in the form of Dr. VanderNat's affidavits, is that actual, profitable retail sales are minimal. As stated in *Koscot*:

“That these schemes so often do not allow recovery of investments by means of retail sales either merely points up that there is very little positive value to be lost by not allowing such schemes to get started in the first place.”

86 F.T.C. at 1181. The *Omnitrition* court also noted the questionable value of a 'retail sales' rule:

On its face, *Omnitrition's* program appears to be a pyramid scheme. *Omnitrition* cannot save itself simply by pointing to the fact that it makes some retail sales. See *In re Ger-Ro-Mar, Inc.*, 84 F.T.C. 95, 148-49 (1974) (that some retail sales occur does not mitigate the unlawful nature of pyramid schemes), rev'd on other grounds, 518 F.2d 33 (2d Cir.1975). 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 it unlikely that meaningful opportunities for retail sales will occur.

The final element to this analysis is the question, what are in fact retail sales? Even though *Koscot* is explicit that commissions may only be paid on 'consummated' sales, and that sales must be to persons who are not participating in the plan, many MLM firms, as well as the DSA, argue that sales to participants should be considered to be 'retail sales' because they are buying for their own use.<sup>38</sup> That is, a purchase of inventory by a participant, in order to qualify for

---

<sup>38</sup> For instance, Amway now argues that there is no distinction between external retail sales and sales to its own salespeople. In an on-camera interview (<http://online.wsj.com/article/FE12F29C-D022-42B8-8ACD-16A114E0DA96.html#!FE12F29C-D022-42B8-8ACD-16A114E0DA96>) with Dennis Berman of the *Wall Street Journal*, Doug DeVos addressed the issue (16:20 - 17:00) :

benefits through recruiting, can be considered a retail sale because the products might be personally used by the participant. Considering the extensive evidence of victim losses approaching 99%, the questionable corporate verifiability of the entire retail sales issue, and the inherent conflict between this legal stance and the documented realities of pyramid recruiting, this expansive view is not consistent with responsible enforcement and would essentially negate the critical requirement for 'retail sales' as an element of a pyramid scheme.

In BurnLounge, which is currently on appeal, the injunction explicitly dealt with this issue in a manner entirely consistent with Koscot:

“Prohibited Marketing Scheme” means an illegal pyramid sales scheme (see e.g., Webster v. Omnitrition Int’l, 79 F.3d 776, 781 (9th Cir. 1996), Ponzi scheme, chain marketing scheme, or other marketing plan or program in which participants pay money or valuable consideration in return for which they obtain the right to receive rewards for recruiting other participants into the program, and those rewards are unrelated to the sale of products or services to ultimate users. For purposes of this definition, “sale of products or services to ultimate users” does not include sales to other participants or recruits or to the

F.T.C. v. Burnlounge, Case No. CV 07-3654 GW (C.D.Cal., Western Div.) (Amended Final Judgment and Order for Permanent Injunction and Other Equitable Relief Against Defendants Burnlounge, Inc., Juan Alexander Arnold, John Taylor and Rob DeBoer) (emphasis supplied).<sup>39</sup>

---

**WSJ Dennis Berman:** “What percentage of the end products are sold to the general public and not to the Amway salespeople directly?”

**Amway Doug Devos:** “That's always a challenge to kind of find exactly what that number is. But it's a large percentage. Probably... our research probably about at least half or more would go to an end-user and ultimately all of its goes to an end-user. Even if somebody happens to be a distributor, they are their own best customer. So I would say, on a strictly speaking standpoint, a hundred percent, because everyone, at the end of the day, is a customer and they see value in the product or else they wouldn't buy it.”

**Berman:** “Right.”

<sup>39</sup>

Available at <http://www.ftc.gov/sites/default/files/documents/cases/2012/03/120314burnloungeorder.pdf>

## CONCLUSION

The Amway decision has enabled modern MLM firms to escape the rigors of the Koscot definition by adopting the so-called Amway rules. The complexities of determining whether the retail sales rules of a given MLM firm are actually effective in ensuring that compensation is only paid based on retail sales pose a significant barrier to effective enforcement. Ambiguities concerning whether internal consumption constitutes retailing, and how much product must be retailed, and whether or not the distributor should be earning a retail profit, worsen the problem. The need for case-by-case analysis has resulted in limited enforcement and oversight on the part of the Federal Trade Commission, with only two significant MLM prosecutions in the past seven years (Burnlounge in 2007; Fortune Hi Tech Marketing in 2013). The lack of enforcement has caused substantial consumer injury now in the many billions of dollars.

The perceived legitimacy of MLM has enabled US based companies to promote their offerings in other countries. At present it is estimated that 80% of the MLM industry's revenues come from outside the United States. Worldwide annual revenues now total over \$150 billion.

The Koscot model remains the best, clearest method for distinguishing between legitimate MLM programs and pyramid schemes. The Amway model has proven to be a failure.

The victim losses, here and abroad, make it imperative that the Federal Trade Commission take a vigorous pro-active stance in respect to pyramid offerings. This must include an enforcement position which enables detection and litigation prior to the delays currently encountered in recent cases such as Fortune Hi Tech Marketing and Burnlounge. Such a position would include formal investigatory efforts to determine the scope and extent of consumer injury and the verifiability of the Amway rules ostensibly in place. If the Amway rules continue to be used by MLM firms as a means for complying with Koscot, then the MLM firm should be

required to meet its burden of proof to collect and produce evidence of actual retail sales supporting the payment of compensation to its distributors. An absence of critical verifiable data indicating that profitable retail sales are occurring should be grounds for prosecution of an MLM as a pyramid scheme. As in Amway, the defendant will be afforded the opportunity to prove the effectiveness of its procedures designed to protect its victims from the abuses fully documented in Koscot, the cases belatedly brought by the Commission, and the extensive affidavits filed in support of these actions by Dr. Vander Nat.

Ultimately, a formal regulation prohibiting pyramid schemes should be enacted, as stated in Koscot:

A discussion of 'inherent' illegality and capacity to deceive may seem pointless given the more than 4000 pages of transcript detailing the actual deception and injury in which the Koscot plan resulted. Nothing could be further from the truth. It is regrettably clear that responsible authorities, including this Commission, have acted far too slowly to protect

...

The viability of a Federal remedy, however, will depend, if not upon congressional enactment, then upon the willingness of courts to recognize the serious potential hazards of entrepreneurial chains and to permit summary excision of their inherently deceptive elements, without the time-consuming necessity to show occurrence of the very injury which justice should prevent. To require too large an evidentiary burden to condemn these schemes can only ensure that future generations of self-made commercial messiahs

86 F.T.C. at 1181-82. The fact that many current victims of these US based countries are members of minority groups, particularly Latino and African-America, or are in other countries where losses in the billions of dollars are essentially shielded from the public and political forums is an even greater reason to proceed, since these victims have few to speak on their behalf. This is precisely the enforcement role of the Federal Trade Commission, to protect those who cannot protect themselves.

**Douglas M. Brooks**  
**Robert L. Fitzpatrick**  
**Bruce Craig**

**March 13, 2014**

About the authors:

**Douglas M. Brooks**

Law Offices of Douglas M. Brooks  
60 Thoreau Street, No. 219  
Concord, MA 01742  
[\(781\) 424-6737](tel:(781)424-6737)  
[dmbrooks@brooks-law.net](mailto:dmbrooks@brooks-law.net)

Douglas M. Brooks has been a practicing attorney for over thirty years, during which he has represented distributors and franchisees in cases across the country. He has represented distributors in class actions against MLM companies, including cases against Herbalife, Nu Skin, Omnitrition and Consumers Buylines. He was one of the attorneys for the class in Webster v. Omnitrition International, Inc., 79 F.3d 776 (9th Cir. 1996), which is the leading case on the standards for determining whether an MLM is operating as a pyramid scheme. He has represented or advised, on a pro bono basis, a number of consumer organizations devoted to educating consumers about deceptive MLM schemes. Since 1995 he has submitted a series of comments to the FTC in its rule-making proceedings concerning the Business Opportunity Rule and the MLM industry and has advocated for better disclosure and regulation of MLM business

**Robert L. Fitzpatrick**

Charlotte, NC  
[rfitzpatrick@pyramidschemealert.org](mailto:rfitzpatrick@pyramidschemealert.org)  
<http://www.pyramidschemealert.org> <http://www.falseprofits.com/FP/Home.html>

Robert L. FitzPatrick is co-author of *False Profits*. He has served as expert witness/consultant in pyramid scheme cases for the US Dept. of Justice, Attorneys General in four states, and provided consulting/expert services in more than 20 court cases related to pyramid schemes. In 2001, FitzPatrick co-founded *Pyramid Scheme Alert* (<http://www.pyramidschemealert.org>), the first consumer education organization focused on pyramid schemes disguised as “business opportunities.” His booklet, *Pyramid Nation*, was used by regulators in writing China's first anti-pyramid law. In 2005, he was invited to Colombo, Sri Lanka by the Sri Lankan Central Bank to combating pyramid schemes. His [False Profits Blog](#) examines the “Economics, Politics, Legalities, Ethics and Sociology of Pyramid Schemes.” Before writing his book on pyramid schemes, Robert FitzPatrick organized and managed trade associations of independent distributors in three industries. He provided consulting in the field of distributor marketing and sales channel management. Corporate clients included Fujifilm, DuPont, Epson, and many

**Bruce Craig**

New York, NY

Bruce Craig retired from the Wisconsin Department of Justice in 1997, after having served as Assistant Attorney General and litigated consumer cases over a 30-year period. He currently volunteers with a New York public interest firm, New York Legal Assistance Group. When active, he prosecuted a number of pyramid cases in Wisconsin and witnessed firsthand the damage they do to those who had hoped to succeed as individual entrepreneurs only to fail after quitting jobs, using savings, and losing friends (whom they tried to recruit) and spouses. In one deceptive practices case, against Amway in 1983, his office documented, from actual tax returns, that the average net income of the top tier 1% 'direct' distributors (of 20,000 Amway Wisconsin distributors) was minus \$900. Mr. Craig continues to have concern for the victims of these schemes that now number in the millions. He has on several occasions petitioned the Federal Trade Commission to become more active and responsive in this area, including a 2009 communication with the current Director of the FTC's Bureau of Consumer Protection and has filed formal comments in connection with its recently promulgated Business Opportunity Rule.