The Pyramid Scheme Legalization Act of 2017

By Douglas M. Brooks, Bruce Craig and Robert Fitzpatrick

Congress is poised to legalize pyramid schemes. H.R. 3409, deceptively titled the "Anti-Pyramid Promotional Scheme Act of 2017," would make some subtle but significant changes in the definition of "pyramid scheme" that has been developed through FTC case law over the past 40 years. More importantly, the bill includes a secret weapon that would enable pyramid schemes and deceptive multi-level marketing (MLM) firms to operate with impunity. We write to provide some background on the bill and to explain why it is bad for consumers and good for pyramid schemes.

Background

Pyramid schemes are responsible for a tremendous amount of consumer harm. For instance, in the Fortune Hi Tech Marketing case the FTC found that "the overwhelming majority of participants – more than 98 percent – lost more money than they ever made."[1] That one scheme involved 350,000 consumers and resulted in an estimated $169 million in losses, of which only a small fraction was recovered. There are hundreds of MLM firms currently operating which utilize similar compensation plans

and are experiencing similar loss and attrition rates. The cumulative consumer losses caused by such pyramid schemes are staggering – certainly amounting to many billions of dollars.

Over the past five years the controversial world of MLM – where "distributors" can recruit more distributors who can then recruit still more distributors and on and on - has experienced a series of tremors. First, in December of 2012, financier William Ackman announced that his hedge fund Pershing Square had shorted $1 billion worth of stock in the MLM firm Herbalife, claiming that it was a pyramid scheme.[2] Mr. Ackman's announcement sent shock waves through the industry because Los Angeles-based Herbalife was (and remains) one of the largest and most prominent MLM firms in the world and its MLM structure and distributor compensation plan were similar to many hundreds of other MLM firms. If Ackman was correct, most MLMs in existence were pyramid schemes. Ackman's charges were not new – they mirrored allegations that had been made in many lawsuits against Herbalife and other MLM firms for years – but his well-financed research, publicity and lobbying campaign attracted more attention to the MLM industry than it had received in decades. It also initiated an epic battle of the hedge funds between Ackman and rival Carl Icahn,[3] as well as investigations by the FTC and the SEC.[4]

In 2013 the MLM industry shuddered when the FTC and three state attorneys general shut down Fortune Hi-Tech Marketing, an MLM that had been in existence for 12 years, for being a pyramid scheme.[5] Another tremor occurred in 2014 when the Ninth Circuit held that the MLM firm Burnlounge was a pyramid scheme.[6]

Then a full-blown earthquake struck in 2016 when the FTC announced the settlement of its investigation of Herbalife. The FTC filed a complaint which amounted to a blistering indictment of typical MLM recruitment and compensation practices, and a consent decree which included $200 million in restitution for victimized Herbalife distributors, mandated substantial changes to Herbalife's distributor compensation plan, instituted onerous retail sales verification and record-keeping requirements, and imposed seven years of oversight by an independent compliance monitor at Herbalife's expense.[7] The FTC has issued pointed guidance that other MLM firms would be well-advised to restructure their operations to conform to the rigorous requirements of the *Herbalife* settlement.[8]

Perceiving that the MLM business model was in jeopardy, the MLM industry has responded to these developments by proposing legislation that would undo the impact of the *Burnlounge* decision and the *Herbalife* settlement. In 2016 the Direct Selling Association, the lobbying arm of the

MLM industry, drafted H.R. 5230, the ironically titled "Anti-Pyramid Promotional Scheme Act of 2016", which was introduced by Representative Marsha Blackburn (R-Tenn).[9] That bill died in the 114th Congress, but Representative Blackburn introduced a revised version in the current Congress. H.R. 3409 currently has 48 co-sponsors (34 Republicans and 14 Democrats) and has been assigned to the House sub-committee on Digital Commerce and Consumer Protection.[10] Also during this term there was an effort to append a truncated version of the bill to the fiscal year 2018 Financial Services and General Government Appropriations bill via an amendment by Representative John Moolenaar (R-Mich), who is one of the co-sponsors of H.R 3409.[11] This amendment did not survive in the Consolidated Appropriations Act which was passed in March.

What is a Pyramid Scheme?

To appreciate the purpose and impact of H.R. 3409 it is important to understand that there is no definition of pyramid scheme in any federal statute or regulation. Instead, the definition evolved in a series of cases brought by the Federal Trade Commission against MLM firms beginning in the 1970's. The most frequently quoted definition is from *Koscot*, in which the FTC 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.[12]

In *Webster v. Omnitrition*, the Ninth Circuit held that the second element of the Koscot test – recruitment with rewards unrelated to product sales - is the *sine qua non* of a pyramid scheme.[13] In *FTC v. Burnlounge*, the Ninth Circuit clarified that the rewards do not have to be "completely" unrelated to retail sales; an MLM is a pyramid if the rewards are paid "primarily" for recruiting.[14]

The net effect of these decisions is to permit pyramid selling and endless chains to operate if the participants are actually retailing the MLM firm's products to bona fide consumers, and rewards are not paid primarily for recruitment.

The Significance of "Self-Consumption"

H.R. 3409 purports to address two issues related to the determination of whether an MLM is a pyramid scheme. The first issue concerns the effect of "self-consumption." For the uninitiated, "self-consumption," or "internal consumption", is a term invented by the MLM industry to describe the situation where MLM distributors purchase products from the MLM firm but do not resell the products to consumers, but supposedly use or consume the products themselves. The problem of self-consumption is whether the

distributor's purchase is motivated by a bona fide desire to consume or use the products, or whether the purchase is motivated by the desire to qualify for rewards under the MLM compensation plan. As explained by Edith Ramirez, the former Chairwoman of the FTC:

> Simply put, products sold by a legitimate MLM should be principally sold to consumers who are not pursuing a business opportunity. For good reason, the law has always taken a skeptical view of paying compensation to someone based on the presumed "internal consumption" or "personal consumption" of recruits who are pursuing a business opportunity. When a product is tied to a business opportunity, experience teaches that the people buying it may well be motivated by reasons other than actual product demand.[15]

The fact that MLM distributors may have mixed motives for purchasing products complicates the determination of whether a given MLM plan is a pyramid scheme. It requires the FTC to undertake a lengthy, time-consuming and expensive investigation into the actual purchases and sales of products by the MLM's distributors. Such investigations are made more burdensome due to the fact that MLM firms typically do not collect records of their distributors' retail sales.

The most recent circuit-level court to address self-consumption in a pyramid scheme case was *Burnlounge*. In that case the Ninth Circuit, while holding that Burnlounge was a pyramid scheme, rejected the FTC's argument that "internal consumption" could never be considered to be a sale to an "ultimate user." On the other hand, the court also rejected the

defendants' converse argument, and held that it would also be "incorrect to conclude that all rewards paid on these sales [to distributors] were related to the sale of products to ultimate users."[16] After analyzing how the Burnlounge bonus structure operated in practice, the Ninth Circuit concluded that even though some of the "self consumption" might be considered to be retailing, the rewards were paid primarily for recruitment, and therefore Burnlounge was a pyramid scheme.[17]

The complexities inherent in assessing the motivations of MLM distributors in purchasing products reached its acme in the FTC's recent settlement with Herbalife.[18] The FTC's complaint alleged that Herbalife distributors "experience difficulty in selling product to customers outside the network," while Herbalife's "compensation structure puts pressure on Distributors to purchase large quantities of product in order to qualify for greater wholesale discounts and recruiting-based rewards."[19] The FTC then alleged that Herbalife distributors disposed of excess products by giving or throwing it away, or by gradually consuming it themselves.[20] Significantly, the complaint alleged that "[s]uch self-consumption is not driven by genuine demand for the product, but is the easiest and most convenient way for a Distributor to get some benefit from product that the Distributor would not have bought absent his or her participation in the business opportunity."[21] In

the consent order, which also imposed $200 million in restitution and a seven-year monitoring regime by an independent compliance monitor, Herbalife was required to implement a comprehensive set of changes to its compensation plan, including retail sales verification and record-keeping, much of which was designed to preclude the payment of rewards to distributors based on purchases by other distributors unless those purchases were undoubtedly motivated by bona fide retail demand.[22]

The definitions of "pyramid promotional scheme" and "ultimate user" in H.R. 3409 may appear to be similar to the usage of those terms in *Burnlounge* and *Herbalife,* but there are significant differences that, if enacted, would make it difficult if not impossible for the FTC to prove the existence of a pyramid scheme. Under the bill, the definition of "pyramid promotional scheme" shifts the word "primarily" to modify the phrase "related to the sale of products or services to ultimate users" instead of – as in *Burnlounge* – modifying the phrase "based upon recruiting other individuals into the plan or operation." The purpose of this change is revealed by the bill's definition of "ultimate user," which is "an individual who consumes or uses the product or service, whether or not the individual is a participant in the plan or operation." This seemingly innocuous change eliminates the crucial issue of the distributor's motivation in purchasing the

product. A distributor who initially purchases a product for the purpose of meeting some qualification in the compensation plan, but later uses or consumes the product because she is unable to sell it, would be considered to be an "ultimate user". This would reverse the result in Herbalife where, as noted above, the FTC's complaint alleged that this type of "self-consumption" could not be considered to be retail selling.

How to Protect Pyramid Schemes

While the issue of self-consumption is important, the main impact of H.R. 3409 is that it would enable MLM firms to inoculate themselves against pyramid scheme allegations. We refer to the bill's extraordinary treatment of "inventory repurchase agreements." In a nutshell, all MLM plans – including operations that would be otherwise be considered pyramid schemes – would be lawful under H.R. 3409 so long as they include "bona fide" inventory repurchase agreements. Much of the verbiage in the bill is devoted to the definition of "bona fide inventory repurchase agreement" and the various happy consequences that pertain to MLM plans that implement such agreements.

Careful study of H.R. 3409 reveals this legislative sleight of hand. Section 2 of the bill prohibits the operation of a "pyramid promotional scheme." That might be considered a good thing, but Section 2 goes on to

expressly exempt from prosecution any plan or operation that does not require "inventory loading" and which implements a "bona fide inventory repurchase agreement." The stricture regarding "inventory loading" is surplusage, since the definition of "inventory loading" in Section 3 expressly exempts such practices so long as they are subject to a "bona fide repurchase agreement."[23] Accordingly, if the plan includes an inventory repurchase agreement it is conclusively presumed that there is no inventory loading. Here's the rub: Section 2 provides that "nothing in this Act may be construed to prohibit a plan or operation, or to define a plan or operation as a pyramid promotional scheme … so long as the plan or operation … implements a bona fide inventory repurchase agreement." Thus, the bill permits any MLM plan with an inventory repurchase agreement to operate with impunity *even if it would otherwise be considered a pyramid promotional scheme*.

So, what is a "bona fide" inventory repurchase agreement? The definitional section of the bill is quite detailed on this point.

First, the MLM firm is only required to repurchase "current and marketable" inventory at 90% of the distributor's original net cost. This may sound reasonable, but the bill's definition of the phrase "current and marketable" expressly excludes goods that are "discounted, seasonal, a

special promotion item, *or not subject to the plan or operation's inventory repurchase program."* This is the proverbial exception that swallows the rule. The bill does not limit an MLM firm's power to designate any or all of its products as not subject to the inventory repurchase agreement. It merely requires that there be "disclosure of any inventory not eligible for repurchase under the program."[24]

Second, the agreement to repurchase is subject to "commercially reasonable terms." The term "commercially reasonable" is notoriously imprecise and ambiguous.[25] The bill defines "commercially reasonable" as requiring the repurchase to take place within 12 months after the date of purchase at not less than 90% of the original net cost, "less appropriate set-offs and legal claims, if any." This last qualification provides another escape route for the MLM firm, as there is no limitation on what set-offs might be deemed "appropriate" nor on what "legal claims" might be imposed.

Third, the repurchase requirement only applies "at the termination of the participant's business relationship with the plan or operation." MLM agreements typically provide that distributors may terminate at will, but in doing so they must give up any rights to commissions generated by their downline in the future.[26] This means that in order to obtain the "benefits" of

the repurchase agreement, the MLM participant must forfeit all current and future rewards from all past investments of time, effort and money, and give up any hope of gaining income. This is a huge barrier that would cause many not to seek refunds.

Accordingly, under H.R. 3409 the requirement of an inventory repurchase agreement would impose minimal burdens on the MLM firm and would provide very limited if not illusory benefits to the MLM participant. However, the practical effect of this bill would be extraordinary. Any MLM firm could evade prosecution as a pyramid scheme by the simple expedient of adopting an inventory repurchase agreement. Is there any other category of unfair or deceptive practice where the perpetrator can obtain immunity simply by offering to refund his or her ill-gotten gains if the victim requests it? We have looked and we haven't found any. In fact, the FTC has expressly rejected this proposition:

> As in any business opportunity, it can be a beneficial practice if an MLM allows participants to return unsold product to the MLM because the ability to return product can decrease the risk of losing money for participants who take advantage of that policy. Allowing participants to return product, however, does not in and of itself shield an unfair or deceptive compensation structure from law enforcement. As a general matter, money-back guarantees and refunds are not defenses for violations of the FTC Act. Even where such policies are offered, dissatisfied participants may not seek a refund for a number of reasons, including because they are unaware of their right to a refund, the refund process is too complicated or obscure, or they blame themselves for not being able to sell the product.[27]

Adopting an inventory repurchase agreement would give the MLM firm a free pass to operate a scheme in which inventory loading is encouraged or required, where the purchase of products can be required as the price for the right to receive rewards for recruiting new participants, and in which participants are the only buyers of the goods sold through the MLM plan – a classic pyramid scheme. This would be a radical change in existing pyramid scheme law. No court has ever held that an MLM firm is immune from prosecution as a pyramid scheme solely by virtue of its promise to repurchase inventory it sold to its distributors. While the "Amway rules" endorsed by the FTC in its 1979 decision included a "buyback" requirement, they also included a 70% rule and a 10-customer rule.[28] It was the combined effect of these rules which the FTC found at that time were both enforced and actually effective in insuring that sufficient products were sold to actual consumers.[29]

Conclusion

Under H.R. 3409, the critical requirement that the rewards for MLM participants be primarily based on actual, profitable retail sales to non-participants, would be eliminated, wiping out almost 40 years of legal precedent and consumer protection measures. Moreover, MLM firms would

be given a free ticket to operate as pyramid schemes through the simple expedient of adopting an illusory repurchase policy. H.R. 3409 is pro-pyramid, anti-consumer and should not become law.

About the Authors:

Douglas M. Brooks has litigated a number of class actions against MLM firms, including *Webster v. Omnitrition*, 79 F.3d 776 (9th Cir. 1996), one of the leading cases. Robert Fitzpatrick has been researching and writing about MLM for over 20 years, and has served as a consultant or expert witness in MLM cases for four state regulators, the Department of Justice and many private civil actions. Bruce Craig is a retired Wisconsin Assistant Attorney General who prosecuted MLM firms such as Holiday Magic, Fortune in Motion and Amway.

[1] https://www.ftc.gov/news-events/press-releases/2014/05/ftc-settlement-bans-pyramid-scheme-operators-multi-level

[2] *See* "Ackman Outlines Bet Against Herbalife," N.Y. Times (December 20, 2012), available at https://dealbook.nytimes.com/2012/12/20/ackman-outlines-bet-against-herbalife/

[3] https://www.theatlantic.com/business/archive/2013/01/bill-ackman-carl-icahn-cnbc/319060/

[4] https://dealbook.nytimes.com/2013/01/09/s-e-c-opens-investigation-into-herbalife/ https://www.wsj.com/articles/federal-trade-commission-starts-herbalife-probe-1394646213

[5] https://www.usatoday.com/story/money/personalfinance/2013/01/28/fhtm-shut-down-pyramid-scheme/1870527/

[6] *FTC v. Burnlounge, Inc*., 753 F.3d 878 (9th Cir. 2014).

[7] https://www.ftc.gov/news-events/press-releases/2016/07/herbalife-will-restructure-its-multi-level-marketing-operations The consent order in *FTC v. Herbalife International of America, Inc.* is available at https://www.ftc.gov/system/files/documents/cases/160715herbalife-stip.pdf

[8] *See* Federal Trade Commission, "Business Guidance Concerning Multi-Level Marketing", issued January 2018, available at https://www.ftc.gov/tips-advice/business-center/guidance/business-guidance-concerning-multi-level-marketing (hereinafter, "FTC Business Guidance").

[9] https://www.govtrack.us/congress/bills/114/hr5230

[10] https://www.govtrack.us/congress/bills/115/hr3409/details

[11] http://thehill.com/blogs/pundits-blog/economy-budget/344373-why-pyramid-schemes-are-angling-to-make-themselves-immune

[12] *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).

[13] *Webster v. Omnitrition*, 79 F.3d 776 (9th Cir. 1996). One of the authors (Brooks) was counsel for the plaintiffs in *Omnitrition.*

[14] *Burnlounge, supra*, 753 F.3d at 885-86.

[15] Keynote Remarks of FTC Chairwoman Ramirez, Direct Selling Association Business & Policy Conference, Washington, DC (October 25, 2016), page 6, available at https://www.ftc.gov/system/files/documents/public_statements/993473/ramirez_-_dsa_speech_10-25-16.pdf (hereinafter "Keynote Remarks").

[16] 753 F.3d at 886-87.

[17] 753 F.3d at 887-88.

[18] As the FTC stated in its recent guidance for the MLM industry:

> Orders obtained through settlements of FTC law enforcement actions are not binding on the entire industry. Such orders, however, can be useful to MLMs that are not bound by them. Industry members may choose voluntarily to follow the provisions in these orders or to consider the provisions in developing their own practices and procedures. All industry members have an obligation to follow the law, and the provisions in FTC orders may provide guidance and insights to help them do so.

FTC Business Guidance at item 12.

[19] *FTC v. Herbalife*, Complaint for Permanent Injunction and Other Equitable Relief, ¶72, available at https://www.ftc.gov/system/files/documents/cases/160715herbalifecmpt.pdf (hereinafter Herbalife Complaint).

[20] Herbalife Complaint, ¶74.

[21] Herbalife Complaint, ¶74.

[22] *See generally*, Keynote Remarks, pages 7-10. The consent order in *FTC v. Herbalife International of America, Inc.* is available at https://www.ftc.gov/system/files/documents/cases/160715herbalife-stip.pdf

[23] We assume that the omission of the word "inventory" in this definition was unintentional, since the remainder of the bill repeatedly uses the phrase "inventory repurchase agreement."

[24] Importantly, the requirement that the terms of the inventory repurchase agreement be "commercially reasonable" only applies if the goods are "current and marketable." There is no requirement that the designation of goods as not subject to the inventory repurchase agreement be commercially reasonable.

[25] *See generally*, Esposito, G. and Kaufman, J., "'Best Efforts', 'Commercially Reasonable' and Other Terms No One Understands," New York Law Journal (March 14, 2016), available at https://media2.mofo.com/documents/160314besteffortscommerciallyreasonable.pdf

[26] *See* Herbalife Complaint at ¶73 ("Although Defendants have a buy-back policy, in order to take advantage of the policy, a Distributor must resign his distributorship. Many Distributors have been unaware of the policy or, for various reasons, have been reluctant to attempt to use it.").

[27] *See* FTC Business Guidance, at item 7.

[28] *In re Amway*, 93 F.T.C. 618, 716 (1979).

[29] *Amway* enabled the tremendous growth of the MLM industry after 1979, since most MLM firms adopted some version of the "Amway rules" as if they provided a safe harbor from FTC enforcement actions. However, *Omnitrition* and *Burnlounge* have limited *Amway* to its facts. *See Burnlounge*, 753 F.3d at 886 (distinguishing *Amway;* noting that Amway had rules that it "effectively enforced" that discouraged inventory loading); *Omnitrition*, 79 F.3d at 782-84 (explaining that in *Amway* the Administrative Law Judge found after a full trial that Amway's rules were enforced and actually effective in preventing inventory loading). *See also* Keynote Remarks, *supra*, at p. 10 ("The Commission found those policies were effective given the specific facts in *Amway* but neither the Commission nor the courts have ever endorsed those policies for the MLM industry at large.").