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## IS MY COMPANY A LAWFUL MLM COMPANY OR AN ILLEGAL PYRAMID SCHEME?

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MLMs are often accused of being illegal pyramid schemes. If the MLM is deemed to be a pyramid scheme, then the ramifications can be devastating. Every state has laws against pyramid schemes (usually referred to as endless chain schemes) and the Federal Trade Commission considers a pyramid scheme to be a deceptive trade practice under Section 5 of the FTC Act. Moreover, an MLM that is considered an illegal pyramid scheme opens itself up to civil claims such as class actions under various state unfair business practices law. The bottom line is that it is vitally important that your company operates a legal MLM versus an illegal pyramid scheme.

The question therefore is what constitutes a lawful MLM as oppose to an illegal pyramid scheme?

The test for determining whether a MLM is a pyramid scheme is if the MLM requires “the payment money of by participants to the company in return for which they receive (1) the right to sell a product and (2) the right to receive the program rewards in return for recruiting *other participants into the program rewards which are unrelated to sale of the product to ultimate users.*”<sup>1</sup> More simply stated, if a company pays recruitment fees, either directly, or hidden within overpriced or worthless product purchase requirements, the company is operating an illegal pyramid scheme.

A distinguishing characteristic of an unlawful pyramid scheme is that it may saturate the market of potential participants to the point where it is unrealistic to expect that such a large number of individuals will become involved and the pyramid must therefore eventually collapse.<sup>2</sup> On the other hand, the primary purpose of a lawful MLM as opposed to an illegal pyramid scheme is to sell **products with real value to end users**, and not to reward associated individuals simply for recruiting more distributors.<sup>3</sup>

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<sup>1</sup>*Webster v. Omnitrition International*, 79 F.3d 776 (9<sup>th</sup> Cir. 1996); *In re Koscot Interplanety, Inc.*, 86 F.T.C. 1106 (1975)

<sup>2</sup> (*See Five-Star Auto Club*, 97 F. Supp.2d at 518 (S.D.N.Y. 2000))

<sup>3</sup> (*See Gold Unlimited Inc.*, 177 F.3d at 483-84, 1999.)

Given the above principles, I believe the proper method to analyze whether a MLM is lawful or a pyramid scheme is to ask the following four questions:

1. Does the product sold by the MLM have real value or is it nothing more than a disguised recruiting fee?
2. Are there more customers than distributors or are all products only consumed by distributors with no retail sales to non-distributor customers?
3. If the last person to join the MLM as a distributor is forbidden to recruit any more distributors, could that person recover his or her initial purchase and profit by retailing the products and services?
4. If the company ceases to recruit any more distributors, would retail sales alone allow the company to sustain operations?
5. Are the profits generated from the sales of the MLM's legitimate products (as oppose to revenue from sign-up or recruiting fees) sufficient to pay for all of the commissions paid to the distributors?

### **DOES THE PRODUCT HAVE REAL VALUE?**

Some MLMs sell products with real or little value for over inflated prices. These may come in the form of membership cards, internet malls, or products that have no real use. Such products are generally considered to be disguised or hidden recruiting fees. In order to avoid this, the MLM should ensure that its product has real value on the market. One way to accomplish this is to look at non-MLM competitors to see if similar products are sold and if so at what price. If the non-MLM competitors' product is sold at a substantially lower price, then something is wrong, and the MLM runs the risk of being accused of selling a product which is nothing more than a disguised recruiting fee.

Another method to ensure that the product has real value (and the method generally accepted by the industry) is whether the product can be sold to customers *who are not distributors of the MLM*. If the product has real value, then it will be attractive to members of the public as oppose to the distributors of the MLM. This is why many MLM's employ the so-called "Amway Rule" which requires the distributor to make at least ten retail sales each month (i.e. sales to non-distributors) in order to qualify for a commission. If, on the other hand, the product is attractive only to distributors, then chances are it has no real value and is a disguised recruiting fee.

### **ARE THERE MORE CUSTOMERS THAN DISTRIBUTORS?**

Closely aligned with the idea that a lawful MLM is in the business of selling product to the public is the concept that there should be more customers than distributors. If, as stated above, the only true customer base are the distributors, then there is something wrong and the

MLM runs the risk that it will be considered as selling a product which is really a recruiting fee and thus a pyramid scheme.

### **CAN A DISTRIBUTOR PROFIT WITHOUT MORE RECRUITING?**

If the MLM is lawful and sells a real product to the public through independent distributors, then a distributor should be able to make a reasonable profit by not recruiting. If, on the other hand, the primary activity of the MLM is to recruit, recruit, and recruit more distributors as oppose to selling product, and the distributors are really earning their money by bringing in more distributors, then the MLM runs the substantial risk of being deemed an illegal pyramid scheme.

### **IF THE COMPANY STOPS RECRUITING WOULD THE COMPANY SURVIVE?**

This, in my mind, is the acid test of whether a company is a lawful MLM or an illegal pyramid scheme. In a true, legitimate company, the company should be able to survive and earn a profit from the sale of its legitimate products *not from the recruiting of distributors*. Therefore, once an initial base of distributors is acquired, the company should be able to survive without bringing on any more distributors. If, however, distributors leave because they are not able to further recruit or the company cannot survive because of the cessation of recruiting, then, sadly, the company is probably nothing more than a pyramid scheme. In other words, once the company has established operations and generated a reasonable distributorship base, the hard question should be asked of whether the company could survive if recruiting of additional distributors ceased. If the answer to this question is no, then the company should be concerned about being an illegal pyramid scheme.

### **ARE PROFITS FROM THE SALE OF PRODUCTS SUFFICIENT?**

In most legitimate companies the profits generated from the sale of products are sufficient to pay the cost to distribute the product. Exceptions, of course, occur on occasion when a company sales a product as a loss leader. In the context of an MLM focus should be made on the legitimate products of the company. If the amount of profits generated from the legitimate products are not enough to pay for the cost of distributing that product then something may be amiss. In such a case, the company may be paying bonuses and commissions to distributors from other sources of revenue such as sign-up or recruitment fees. If this is the case, then the company runs the substantial risk of being considered a pyramid scheme. Therefore, the MLM company should, in most cases, take measures to ensure that the profits generated from the sale of its profits are sufficient to pay for the bonuses and commissions paid to the distributors.

MLM companies can be very successful, legal operations. However, the MLM operator must be concerned with the risks of his or her business. There is no greater risks than being deemed an illegal pyramid scheme. The company should therefore carefully structure and plan its operations and profits so that it avoids this designation.