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Social Media Start-Up Capital: Don't Try a Ponzi Scheme

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You've got the perfect idea for a social media site, but how do you attract a critical mass of members to launch it? Your credit cards are maxed out and your friends and family are tapped too. Can you attract members by offering to pay cash incentives for recruiting other members, who in turn recruit other members and then others (known as "downline recruits")?

The Federal Trade Commission and Ninth Circuit Court of Appeals have answered that question with a no, if the primary incentive is cash from the recruitment program. *(Federal Trade Commission v. BurnLounge, Inc., et al., Nos. 12-55926, 12-56197, & 12-56228 (Ninth Circuit Ct. of Appeals) June 2, 2014).* The *BurnLounge* defendants were enjoined from operating an illegal pyramid scheme in violation of Section 5(a) of the Federal Trade Commission Act. The proceedings may be accessed at http://www.ftc.gov/enforcement/cases-proceedings/062-3201/burnlounge-inc.

What exactly did defendants do? BurnLounge operated an online, multi-level marketing ("MLM") business. Although customers could directly buy music and merchandise, BurnLounge's primary business was selling turnkey web stores. Through purchases, these "Independent Retailers" could earn credits redeemable for music and merchandise. This aspect of the business wasn't the problem, according to the Ninth Circuit. Where it violated the law was by selling Retailers an enhanced position as a "Mogul." This group received cash "concentric retail bonuses" for music, merchandise, and package sales made through their own site and through the sites of their downline recruits. In actuality, the bonus payments were primarily derived from the number of new recruits.

The legal test was this: Is the MLM "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"? The Court acknowledged that not all MLMs are pyramid schemes. It depends on how it operates. In *BurnLounge*, the evidence proved that participants were motivated by the recruitment bonuses, and not by retail marketing efforts.

Returning to the problem how to raise startup capital, could the entrepreneur solicit advance orders for its future site through crowdfunding? Are Kickstarter purchasers considered investors or purchasers? The answer isn't settled, although a company having the resources to deliver on its orders, and that does deliver, would seem to be safe as an old-fashioned seller of goods. But failure to deliver can be risky. The Attorney General of the State of Washington sued a Tennessee company that allegedly failed to deliver promised products. (*Washington v. Altius Management LLC, Wash. Super. Ct., No. 14-2-12425-SEA, April 30, 2014.*) Altius had raised over $25,000 from 810 backers for a line of playing cards, which it allegedly failed to deliver, and it couldn't refund the money. The Washington Attorney General asserted that this constituted unfair or deceptive trade practices under the Washington Consumer Protection Act. Altius had made promises about the level of funding and distribution of product on its Kickstarter site, and it didn't live up to those promises. Other states have consumer protection statutes, and they all have attorneys general. The complaint can be found at www.atg.wa.gov/uploadedFiles/AsylumComplaint%202014-05-01.pdf. Since Kickstarter generally has a higher funding requirement than some of its newer competitors, a company attempting advance sales should on its own carefully assess what the true level of funding is for its project to succeed.