Fashion Apparel Law Blog

Posted at 8:45 AM on May 18, 2009 by Sheppard Mullin

Ding-Dong!! Multi-level Marketing Plans Calling!!

Multi-level marketing plans ("*MLMs*"), also known as "network" or "matrix" marketing plans, can be an effective way for the "little guy" or the "entrepreneur" to achieve financial success in the cosmetics or apparel industry.[1] By promoting individual autonomy and embracing the concept that the independent sales person is the main driver of success, it's no surprise that MLMs are attracting considerable talent. In fact, the Direct Selling Association, a trade group that includes the leading multi-level marketing firms, reports that the industry employed more than 15 million U.S. salespeople in 2007, and had an estimated $30 billion in U.S. direct sales. Further, the clothing, cosmetics, and personal care segment represented almost a third of all domestic sales, the highest of any major product group.

However, success comes with a price, and in this case—an image problem. Specifically, the MLM industry has been widely criticized that its business models are nothing more than an illusory pyramid or ponzi scheme. But this accusation is only skin-deep. While it's fair to say that some companies are a sham, the truth is that an MLM plan, *if properly set up*, is a completely legal business model that can offer substantial benefits to its members. Therefore, potential participants must check beneath the surface of any MLM plan to determine whether the rewards promised can actually be attained.

Courts have offered a few tips in distinguishing between a legal MLM plan and an illegal pyramid scheme. In the classic case of *Amway Corp., Inc*., the court noted that Amway was a legitimate MLM because it was a substantial manufacturing company that distributed "actual" products [93 F.T.C. 618 (1979)]. Further, Amway implemented several policies (now known as the "*Amway safeguards*") that "avoided the abuses of pyramid schemes" [*Id*. at 700]. These safeguards include:

1. <u>No Headhunting Fee</u>

First, Amway did not have "headhunting fees" or commissions on mandatory inventory purchases by the recruits [*Id*. at 717]. Rather, the only investment needed was a sales kit for $15.60 that could be refunded if the recruit decided to leave the Amway plan [*Id*.]. Additionally, no profit was made on the sale of the kit [*Id*.]. In other words, a sponsoring distributor received nothing for the *mere act* of recruiting a new distributor. Only when products are sold did the sponsoring distributor begin to earn commission.

2. Product Sales a Precondition to Receiving a Performance Bonus

Second, Amway commissions were earned *only* when distributors resold at least 70% percent of the products they purchased each month [*Id*. at 646]. The "70% Rule" prevented the accumulation of inventory and encouraged distributors to get their products out to consumers [*Id*. at 716].

3. Buying-Back Policy

Third, Amway bought back unused marketable products from a distributor whose inventory did not move or who wished to leave the business [*Id*. at 646]. This deterred unlawful inventory loading, where a sponsoring distributor is inhibited from pushing unrealistically large amounts of inventory onto her new recruits for the sake of increasing her performance bonus [*Id*. at 716].

4. Requirement that Products are Sold to Customers

Fourth, Amway required ongoing sales to retail customers. For instance, Amway's "Ten-Customer Rule" provided that distributors do not receive a performance bonus unless they prove a sale to each of ten different retail customers during each month [*Id*. at 646]. Such a rule made retail selling an essential part of being a distributor.

Where the Amway case described characteristics of a legitimate MLM plan, a number of suits brought by the FTC against clothing and cosmetics distributors have provided guidance as to what constitutes an illegal pyramid scheme [*See Ger-Ro-Mar, Inc.*, 84 F.T.C. 95 (1974) (cosmetics); *Holiday Magic, Inc.*, 84 F.T.C. 748 (1974) (cosmetics and toiletries); *Koscot Interplanetary, Inc.*, 86 F.T.C. 1106 (1975) (brassiere, lingerie, and swimwear)]. In a typical pyramid scheme, revenue primarily comes from recruitment *alone*. The new recruits are usually required to invest money to participate in the plan; such investment goes towards a "money pool" that becomes the primary source of income for those higher in the pyramid. Unlike a legitimate multi-level marketing plan, an illegal pyramid scheme has no substantial product to sell and therefore does not derive revenue from such sales. Rather, capital acquisition is based on recruiting efforts that are unrelated to the sale of the product to ultimate users. In other words, for the company to sustain itself, members will have to continually recruit others to increase the money pool—if they do not, the pyramid collapses. Companies involved in a pyramid scheme are usually more focused on recruiting than selling, require substantial fees upfront, do not allow for returnable inventory, and pay scant attention to consumer sales.

In the end, the MLM industry is like any other industry. Some businesses are golden apples, while others are simply rotten apples. Therefore, before investing in an MLM plan, one must check its details and see if there are safeguards in place that impede the development of a pyramid scheme, where participants purchase a right to earn profits by simply recruiting other distributors, who themselves are interested in recruitment fees rather than the sale of products. For additional help with identifying pyramid schemes, please visit: www.ftc.gov/edu/consumer/invest/inv12.shtm

[1] Multi-level marketing plans typically offer distributors a commission for both sale of the plan's goods or services and sales by others that they have recruited to join as distributors. For example, every time Distributor A recruits a new Distributor B (usually a friend, family member, or neighbor), Distributor A will receive a commission from all sales made by Distributor B. Further, if Distributor B recruits a Distributor C, Distributor A may continue to receive commission through both levels of recruits (e.g., Distributor A's "downline"). In other words, Distributor A earns a commission on both his independent sales efforts as well as the leveraged sales efforts of his downline.