

# MLM LAWS IN 50 STATES

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Every state has adopted laws regulating MLM companies. Although much enforcement activity has come from the federal government through the FTC, SEC and U.S. Postal Service, the vast majority of enforcement activity has occurred at the state level.

From a historical standpoint, state regulation of multilevel marketing programs is a relatively recent phenomenon. For the most part, the three major direct selling companies that laid a foundation for the multilevel marketing industry for decades to come, Amway, Mary Kay and Shaklee, began their operations in the late 1950s. From a legal standpoint, matters went relatively smoothly until the major pyramid cases of the early 1970s involving Glen Turner's Dare to be Great and Koscot Interplanetary.

The Turner programs were prosecuted substantially [www.mlmlegal.com](http://www.mlmlegal.com) under securities laws and various consumer fraud laws. Along the way, most states adopted various forms of anti-pyramid legislation. Although generally targeting the same type of activity, state MLM legislation has taken its form as pyramid statutes, endless chain scheme statutes, lottery statutes, sales referral laws and, most recently, multilevel distribution statutes.

## **Pyramid Statutes/Endless Chain Schemes Statutes.**

Most state regulation of MLM companies comes under the auspices of pyramid statutes and endless chain scheme statutes. The language in these statutes is often quite similar. The comparison of two of these type statutes illustrates this point. For instance, compare California's endless chain statute with Oregon's pyramid law.

California Endless Chain Statute, California Penal Code '327:

"327. Endless chain schemes

"Every person who contrives, prepares, sets up, proposes, operates any endless chain is guilty of a misdemeanor. As used in this section, an 'endless chain' means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include

payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme."

Oregon Pyramid Statute:

"pyramid club" means a sales device whereby a person, upon condition that the person make an investment, is granted a license or right to solicit or recruit for economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and who may further perpetuate the chain of persons who are granted such license or right upon such condition. "Pyramid club" also includes any such sales device which does not involve the sale or distribution of any real estate, goods or services, including but not limited to a chain letter scheme. A limitation as to the number of persons who may participate, or the presence of additional conditions affecting eligibility for such license or right to recruit or solicit or the receipt of economic gain therefrom, [www.mlmllegal.com](http://www.mlmllegal.com) does not change the identity of the scheme as a pyramid club. As used herein "investment" means any acquisition, for a consideration other than personal services, of property, tangible or intangible, and includes without limitation, franchises, business opportunities and services. It does not include sales demonstration equipment and materials furnished at cost for use in making sales and not for resale."

As a general matter, the pyramid and endless chain statutes prohibit the payment of a consideration for the right to recruit others for economic gain where the compensation is unrelated to the sale of products or services. This language is very ambiguous and has resulted in legions of cases, many inconsistent in outcome. The ambiguity of the statutes has also led to selective and inconsistent enforcement policies.

Two operative terms "consideration" and "compensation unrelated to sales" are often looked at as follows. A prohibited consideration is generally referring to: (1) an actual monetary fee for the right to engage in the multilevel business, (2) inflated product prices in which the excess product price is viewed as a prohibited consideration, (3) front-loading or inventorying of product in which excessive product purchases are viewed as prohibited consideration for the requirement that individuals make an initial investment of product purchased to engage in the opportunity, (5) where it appears that people are only buying product in order to "buy into the deal," and (6) many statutes, although not all statutes, exempt from the term "prohibited consideration," the purchase of an at cost sales kit or demonstration materials.

The receipt of compensation unrelated to sales typically references: (1) payment of actual headhunting fees for finding other recruits, (2) a program in which sponsors make all of their compensation from override commissions from loading recruits with unnecessary product, (3) a program in which there is no evidence of sales outside the network of distributors.

In the leading decisions in this subject area, a variety of abuses have been targeted as potential elements of illegal marketing plans:

1. Products which have "no real world" marketplace.
2. Products which are sold at inflated prices.

3. Mandatory purchases of company product.
4. Plans which result in inventory loading distributors.
5. Substantial cash investment requirements.
6. Mandatory purchases of peripheral or accessory products or services.
7. Plans in which company products are totally or substantially consumed only by distributors.
8. Plans in which distributors are left with substantial unsold inventory upon cancellation of participation.
9. Plans in which distributors purchase products in order to further the marketing plan rather than out of genuine desire and need for the product.
10. Plans which would fail without purchases by participants.
11. Plans which make no effort to emphasize retail sales to the ultimate nonparticipant consumer.
12. Plans which require no meaningful participation by distributors after becoming a distributor.
13. Plans in which fees are paid to distributors for headhunting.
14. Plans in which commissions are not based on actual retail product sales.
15. Plans in which emphasis is on recruitment rather than sale of product.
16. Plans which contain elements of a lottery rewarding participants based on chance rather than on bona fide sales efforts.
17. Earnings misrepresentations or inflated earnings representations.

### **State Lottery Statutes.**

State lottery statutes typically follow language found in postal lottery statutes which prohibit the payment of consideration for the right to receive compensation which is based on chance. The following is typical language of a state lottery [www.mlmlegal.com](http://www.mlmlegal.com) provision found in an MLM distribution statute:

"offer to pay, pay or authorize the payment of any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration to any participant where payment thereof is or would be dependent on the element of chance dominating over the skill or judgment of such participant, or where no amount of judgment or skill exercised by the participant has any appreciable effect upon any finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration which the participant may receive, or where the participant is without that degree of control over the operation of such plan as to enable him substantially to affect the amount of finder's fee, bonus, refund, override, commission, cross-commission, dividend or other consideration which he may receive or be entitled to receive."

Although the Postal Service has often pursued companies under the lottery theory, most state regulatory action occurs under pyramid legislation rather than lottery legislation. As a general matter, states are more concerned with the structure of an MLM program (i.e. is it a pyramid?) than the question of whether or not the program has so many levels that the payment of commissions appears to be related to "chance." Although the number of levels appears to be important to the U.S. Postal Service, it appears to be less important to the states. Nevertheless, lottery legislation is the operative legislation in some states.

## **State Sales Referral Laws.**

In the aftermath of the door-to-door aluminum siding cases, almost every state adopted a sales referral law which prohibits in the course of a consumer transaction the promise to a consumer of some type of reward in exchange for recommending another consumer, and where the reward is contingent upon the second consumer purchasing product. Although almost all states have sales referral laws, few states have attempted to apply sales referral laws to multilevel marketing programs. In one such case, the State of Iowa attempted to apply its sales referral law to a company called American Professional Marketing, and the court rejected the prosecution. As a general matter, such laws would appear to be inapplicable to multilevel marketing programs because distributors receive their compensation [www.mlmlegal.com](http://www.mlmlegal.com) in their capacity as "independent contractor distributors" and not in their capacity as consumers referring other consumers. The typical language of these statutes is as follows:

"Referral selling prohibited. No seller or lessor may give or offer a rebate, discount, or anything of value to a buyer or lessee as an inducement for a sale or lease in consideration of his giving to the seller or lessor the names of prospective purchasers or lessees, or otherwise aiding the seller or lessor in making a sale to another person, if the earning of the rebate, discount, or other thing of value is contingent upon the occurrence of an event subsequent to the time the buyer or lessee agrees to the sale or lease."

## **MLM Laws/MLM Statutes.**

In the 1980s and 1990s, many states realized that the pyramid statutes should be reserved for chasing after pyramid schemes. A number of states concluded that the multilevel marketing industry was a legitimate industry, but one that needed statutory consumer safeguards. Thus, a number of states, including Massachusetts, Georgia, Louisiana, Wyoming, Maryland and the Commonwealth of Puerto Rico, adopted MLM distribution statutes. Some states, such as New Mexico and South Dakota, which adopted legislation later found that the administration of the statute was in fact burdensome for the state and repealed their MLM registration requirements.

Five states have enacted laws which specifically regulate multilevel marketing companies. They are Georgia, Louisiana, Maryland, Massachusetts and Wyoming. (Puerto Rico has similar legislation.) These state laws define a multilevel distribution company as:

Any person, firm, corporation or other business entity which sells, distributes or supplies for valuable consideration, goods or services through independent agents, contractors or distributors, at different levels wherein participants in the marketing program may recruit other participants, and wherein commissions, cross-commissions, bonuses, refunds, discounts, dividends or other considerations in the program are or may be paid as a result of the sale of such goods and services or the recruitment, actions or performances of additional participants.

Many of these statutes place restrictions on the activities of multilevel marketing companies. One of the most important of these restrictions is the buyback requirement, which grants distributors the right to cancel "contracts of participation" for any reason and at any time and requires that the company repurchase inventory and sales materials from the distributor at a price not less than

90% of the distributor's original net cost, as well as refund fees paid by the distributor. In addition, these five states prohibit companies from representing that distributors have or will earn stated dollar amounts. Although not MLM registration states, Texas and Oklahoma have also adopted a 12-month, 90 percent buyback requirement. Louisiana also requires a 12-month buyback.

In responding to industry concerns regarding arbitrary [www.mlmlegal.com](http://www.mlmlegal.com) enforcement of ambiguous pyramid laws, a number of states have proceeded to upgrade their pyramid legislation to reflect industry standards. For instance, in recent years, a significant debate has arisen between the direct selling industry and regulators as to whether or not personal use by distributors should be accorded the status of a "retail sale" in the same fashion that sales to nonparticipants are accorded "retail sale status." This issue is significant in MLM cases, because regulators often argue that companies are pyramid schemes under pyramid statutes unless the majority of sales are sales of product outside of the network.

The direct selling industry has long recognized the importance of personal use by its distributors and during the 1990s this became a major issue of tension between the direct selling industry, state regulatory agencies and the Federal Trade Commission. As a result, the direct selling industry sought protective "safe harbor" legislation at the state level and at least three states led the way in recognizing "personal use" as a legitimate "retail sale." Those states were Oklahoma, Texas and Louisiana and it was hoped and expected by the industry that many other states would soon follow. Typically the legislation provides that, if a company has a 12-month buyback policy on inventory, then compensation paid on either purchases for personal use or nonparticipant sales will qualify as compensation paid on sales of product. Louisiana is typical of the new legislation:

"'Compensation' for inducing others to join the program does not include payments 'based upon sales of products purchased for actual use or consumption, including products used or consumed by participants in the plan,' nor does it include 'payment to participants under reasonable commercial terms.' Id.

"'Consideration' is defined as not including either the money paid for sales demonstration equipment that is sold on an at cost basis, the time and effort expended in operation of the business, or the 'purchase of products where the seller offers to repurchase the participant's products under reasonable commercial terms.'"

### **State MLM Laws - Important to Understand.**

Although the federal government, through the SEC, FTC and U.S. Postal Service, has played an active role over the years in regulating MLM activity, the vast majority of regulatory action has come at the state level. Therefore, it is important to understand the patchwork of state MLM laws, both as they exist today and as they continue to evolve over time. Working with these laws is fundamental to the operation of an MLM [www.mlmlegal.com](http://www.mlmlegal.com) business by a company or by a network marketing distributor.

*On any given day you can catch Jeffrey Babener, editor of [www.mlmlegal.com](http://www.mlmlegal.com), lecturing on Network Marketing at the University of Texas or the University of Illinois, addressing thousands*

*of distributors in Los Angeles, Bangkok, Tokyo and Russia, or writing a new book on Network Marketing, an article for Entrepreneur Magazine or a chapter for a University textbook. Over two decades he has served as marketing and legal advisor to some of the world's largest direct selling companies, the likes of Avon, Nikken, Shaklee, Tupperware, Prepaid Legal, Longaberger, Melaleuca, Discovery Toys, Usana, Amazon Herb, NuSkin, Cell Tech, Sunrider.... and he has provided counsel to the most successful telecom network marketing companies...Excel, ACN, World Connect, ITI, Acceris, AOL Select and Network 2000. An active spokesperson for the industry, he has assisted in new legislation and served on the Lawyer's Council, Government Relations Committee and Internet Task Force of the Direct Selling Association (DSA) as well as serving as General Counsel for the Multilevel Marketing International Association. He is an MLM attorney supplier member of the DSA and has served as legal counsel and MLM consultant on MLM law issues for many DSA companies. He is author of multiple books, including, Network Marketing: What You Should Know, Network Marketer's Guide To Success, Tax Guide for MLM/Direct Sellers, Starting and Running the Successful MLM Company, The MLM Corporate Handbook and Window of Opportunity. He is author of countless articles on network marketing, many of which can be found at [www.mlmlegal.com](http://www.mlmlegal.com) where he is the editor. You will see his articles and interviews in such publications as Money, Atlantic Monthly, Success, Entrepreneur, Business Startups, Home Office Computing, Inc., Money Makers Monthly, etc. He has been chairman of numerous industry conference series, including, Starting and Running the Successful MLM Company, The MLM Entrepreneur Series and The MLM Masters series. He has served as the close advisor to scores of MLM Companies and their distributors, comprising millions of distributors and billions of dollars in sales. Mr. Babener is a graduate of the University of Southern California Law School, where he served as editor of the USC Law Review. After an appointment to be an advisor law clerk to a U.S. Federal Judge, he went on to become a member of the California and Oregon State Bar, where he has also served as chairman of the Oregon State Bar Committee on Judicial Administration. He has exclusively practiced in the area of direct selling for over 20 years. A Regulatory Update for MLM, Direct Selling, Network Marketing, Direct Sales, Party Plan Independent Distributors and Companies.*