

DIRECT SALES AN OVERVIEW THE LEGAL ENVIRONMENT

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INTRODUCTION

Earlier chapters have laid the foundation for understanding the Direct Sales Industry as a viable and valuable Industry.

Yet since before its recognition as an Industry, Direct Sales companies and salespeople have existed within a framework of misperception on the part of the public, the business community, regulatory agencies, and legal authorities. This has been due, in part, to the unethical or illegal actions of companies and individuals within the Industry, but also in equal if not greater part to individuals who engaged in unethical or illegal www.mlmlegal.com activities while claiming to be legitimate Direct Sales companies or Representatives.

As the Industry has matured, the public has become more conscientious, resulting in courts and regulatory agencies addressing some of the more blatant illegal activities. This has led to a greater ability to discern legitimate companies and Representatives from their illegal counterparts.

Some of the legal challenges that have faced the Industry have stemmed from the confusion over what are legal Direct Sales activities and companies, and what are not. The Chapter presents Ponzi Schemes, Chain Letters, and Pyramid Schemes — three of the most well-known illegal activities that have contributed to a negative perception of the Industry, even though they have never been a legitimate part of it.

This Chapter also addresses how, as the Industry evolved, some companies that operated primarily with legal practices and acted ethically toward their retail customers also engaged in some questionable activities, and what steps have been taken to eliminate such practices.

Readers will learn of the roles that companies, Representatives, Industry associations, the courts, and other regulatory agencies have played in creating legal and ethical operational standards for companies and Representatives, and in defining and establishing companies Representatives, and consumers' rights and responsibilities.

The Chapter addresses how the wide variety of regulatory agency standards and laws, and court and enforcement agency policies and practices affects the Industry.

Readers will also learn the legal climate of the Industry is impacted by the fact companies and Representatives, both of which have rights as independent businesses, sometimes have disparate viewpoints about the same issue. This Chapter addresses how the rights of each party sometimes supercede the rights of the other.

That Representatives retain their status as Independent Contractors is essential to the Industry, and one on which companies and Representatives agree — even though these two entities are not always in agreement about the rights each has. This Chapter addresses how this status forms the foundation for all of the self-employment and tax-related issues upon which the Industry is based.

There is a definite trend toward greater clarity among all the facets of the Industry and of legal and regulatory bodies. Readers will learn how Representatives, companies, Industry associations, and legal authorities are proactively working www.mlmllegal.com closely together to establish standards, and develop consistency in their enforcement.

This Chapter will present landmark rulings related to the Industry, and their ramifications. It also includes the practical effects of the existing legislation and the influence of the legal environment in which the Industry operates.

From this Chapter's content, readers will be able to describe and explain:

- Several basic laws and regulatory standards that impact the operation of Direct Sales companies and Representatives.
- Existing legal determinants of legality and legitimacy.
- The legal and regulatory entities that have influence upon the Industry.
- How differences in interpretations by different legal, regulatory, and Industry entities of existing laws and rulings sometimes results in inconsistent enforcement.
- The relationship between companies and Representatives as independent yet integrated business entities.
- Practical effects of legal rulings upon companies and Representatives.
- The existing legal status of Representatives' purchase of Product for personal use, and the importance of this status to the Industry.

Some of the significant terms defined and described include:

- Pyramid Schemes, Ponzi Schemes, and Chain Letters
- Amway Safeguards Rule
- Mail Fraud
- Postal Lottery Laws
- Securities
- Industry *Code of Ethics*
- Earnings Representations and Potential Earnings www.mlmllegal.com Representations

THE LEGAL ENVIRONMENT FOR THE DIRECT SALES INDUSTRY

The legal history of direct selling activities and the Direct Sales Industry has been characterized by cycles in which the legal climate has vacillated between challenge and support. Today, as the public and legislators become more educated about the Industry, the legal climate is generally positive.

Although still not without legal - and practical - challenges, in general legitimate Direct Sales companies are well received throughout the United States. With increasing frequency, federal and state governments and agencies offer assistance and guidance to the Industry. The Internal Revenue Service (IRS) has adopted regulations which recognize Direct Sales as a legitimate profession, and has created educational literature and videos to educate others about the agency's policies and practices regarding Independent Representatives as Independent Contractors. (In 1982, Congress amended the Internal Revenue Code to specifically recognize Independent Contractor status of direct sellers — Independent Representatives.) Several states have adopted legislation which set forth objective standards for Direct Sales companies to follow. Even in states which currently have no laws specific to the Industry, a legitimate Direct Sales opportunity can easily be distinguished from a Pyramid Scheme or other illegal activities simply by observing some basic objective indicators.

Any industry that offers dramatic rewards with a low cost of entry will tend to attract some of the most talented entrepreneurs and, unfortunately, some of the least ethical as well. Over the years, the Direct Sales Industry has, at times, come perilously close to extinction as a result of prosecution by regulators who claimed it promoted Pyramid Schemes and other "scams" under the guise of legitimate marketing. The most perilous prosecution was the "Amway Safeguards Case," which will be presented in this Chapter.

In many cases, the prosecutors correctly assessed Pyramid Schemes, Chain Letters and other forms of endless chains, lottery games, and Ponzi Schemes — all of which at times have posed as legitimated Direct Sales companies — as illegal and were successful in forcing them to cease operations. Unfortunately, these high-profile cases often contributed to the public's unduly negative perception of the Industry by adding to the confusion about what are illegal activities and what are legal companies.

Direct Sales companies have a strong legal foundation for www.mlmlegal.com legitimate operation. In a classic legal decision in 1979, the Amway Corporation prevailed against a prosecution and received a stamp of approval for its marketing program by the Federal Trade Commission (FTC). This particular decision helped to place existing Direct Sales companies on firmer ground and opened the door to the establishment of many other Direct Sales companies which now had a stronger legal assurance of success. This ruling remains as one of the legal standards for the Industry.

LANDMARK CASES AND RULINGS WHICH AFFECT THE INDUSTRY

THE "PYRAMID" CASES

The Direct Sales Industry was proceeding on a safe legal course until a proliferation of pyramid programs appeared on the scene in the 1970s. A promotion called "Dare To Be Great," promoted by Glen W. Turner, was one example. Like other Pyramid Schemes, the only "commodity" that moved through this program was money. No viable goods or services, sold at fair market value, accompanied the recruiting activities. Virtually every state had residents who were impacted by this and other programs which officials successfully argued were mere "headhunting" schemes.

The FTC established the earliest guidelines regulating illegal pyramids and other unlawful entrepreneurial chains: In *Koscot Interplanetary Inc.*, (1975), the FTC was highly critical of:

- Large membership fees.
- Front-End Loading and Inventory Loading.
- Programs in which distributors were misled as to the amount of commission they might reasonably earn, and
- Programs in which commissions are not based on the sale of Product to ultimate consumers.

The Securities and Exchange Commission (SEC) also stepped into the Dare to Be Great picture, demonstrating that securities statutes also apply to the Industry. In *SEC v. Glen W Turner Inc.* (1973), the U.S. Ninth Circuit Court of Appeals reaffirmed that the securities acts were "designed to protect the American public from speculative or fraudulent schemes of promoters." The Dare To Be Great program was ruled to be an "investment contract" under the securities laws and thus subject to regulation by the SEC. This was a landmark ruling in establishing the distinction between "speculative or fraudulent schemes" and legitimate Direct Sales activities. It also helped establish the SEC's role in upholding the rights of legally operating companies and the right to prosecute offenders.

The Koscot, Dare To Be Great, and other pyramid cases left a sour taste in the mouth of the American public. The decisions during the early 1970s represent a low point in the legal history of the Industry. As a result of the activities of a few, the Industry was penalized by an overreaction by regulatory authorities. State legislators and attorneys general often dedicated themselves to eliminating all forms of Direct Sales activities in an attempt to leave no avenue open for illegal Pyramid Schemes or unethical salespeople to operate within their states' borders. Virtually every state adopted "pyramid" statutes which, unfortunately, are often so vague and ambiguous as to invite arbitrary and capricious enforcement. The www.mlmllegal.com Industry also found itself affected by the application of combinations of Business Opportunity statutes, franchise and security statutes, state lottery, and referral statutes as well as enforcement activity by the U.S. Postal Service through its lottery and fraud statutes. In addition, several states have since adopted additional "multi-level" distribution statutes which are designed to further regulate the Industry.

THE AMWAY SAFEGUARDS RULE

Legal triumphs by companies within the Direct Sales Industry have had a far-reaching impact. Many such rulings have proven very positive not only to the Industry but also to the general conduct of business in the United States.

The FTC's prosecution of Amway in the mid- 1970s could have dealt a death blow to the entire Direct Sales Industry. In *The Matter of Amway, 1979*, the agency attempted to make the case that Amway was a Pyramid Scheme and therefore a deceptive trade practice under FTC consumer laws.

The case lasted several years. Amway prevailed, and in the landmark 1979 ruling its marketing method was ruled to be a legitimate business opportunity. This decision has become known as the "Amway Safeguards Rule," which is currently one of the most significant sets of legal standards by which courts and regulatory agencies determine the legitimacy of a Direct Sales company.

In the court's decision three salutary features were pointed out with respect to the Amway program:

1. *Amway required its Representatives to engage in retail selling*, under the "ten retail customer policy" which appeared in the agreement that Representatives signed upon enrollment. This rule required that Representatives make 10 sales to retail customers as a qualification for eligibility to receive commissions and bonuses on sales/purchases made by other Representatives in their Personal Sales Organization (PSO).
2. *Amway required its Representatives to sell a minimum of 70% of previously purchased product before placing a new order.* (Amway's rules recognize "personal use" for purposes of the 70% rule.) This condition was also spelled out in its Representative Agreement.
3. *Amway had an official "buy-back" policy for unsold, unopened inventory* This policy had some reasonable restrictions, including a specified maximum length of time since the item was originally purchased by the Representative and that the item was still current in the company's product offerings to consumers. The policy also included a minimal "restocking" fee. (buy-back policies are significant especially for their protection of Representatives who choose to terminate their affiliation with a company, and do not want to be "stuck" with unsold inventory.)

By abiding by these three criteria, Direct Sales companies provide themselves with an "umbrella of legal protection." The Amway Safeguards Rule has been www.mlmllegal.com successfully cited many times since 1979 in defense of legally operating companies.

THE AFFECT OF LEGAL RULINGS ON THE DIRECT SALES INDUSTRY

Because of the abuses by unethical individuals and illegal companies operating under the guise of Direct Sales, Network Marketing, or Multi-Level Marketing, the Industry has become closely scrutinized and highly regulated. Regulations regarding Direct Sales companies in the United States are a constantly changing patchwork of overlapping laws, which lack uniformity and vary from state to state.

Industry Associations, including the Direct Selling Association (DSA) and the Multi-Level Marketing International Association (MLMIA) have dedicated a portion of their financial resources and expertise to creating a set of national standards by which companies and Representatives operate, and which protect consumer rights. Both of these associations have adopted *Codes of Ethics* by which member companies www.mlmlegal.com must agree to operate. In addition to providing education dedicated to enhancing the public's and lawmaker's understanding and perception of the Industry, the DSA and MLMIA lobby to enact laws and statutes which are in harmony with these self-imposed Industry standards.

The basic thrust of existing statutes is that Direct Sales companies must be *bona fide* sales organizations which market *bona fide* Product to consumers. Some activities which are prohibited or restricted include:

- *Requiring excessive purchases at the time of enrollment.* This practice is known as "Front-End Loading" "Excessive" is defined as being more than is necessary to fulfill existing or anticipated orders.
- *"Headhunting" or recruiting.* Companies are prohibited from rewarding Representatives solely for another's enrollment – their agreement to participate in the company Commissions or their remuneration must be paid only on actual purchases of goods or services. Purchases made by Representatives at the time of enrollment and thereafter for their own use or resale are generally considered commissionable sales.
- *Excessive charges for training materials,* including "Starter Kits" and other sales support materials. Companies are not required to take a financial loss on these materials, however. To adhere to this rule, most Direct Sales companies provide them at a price which approximates the actual cost of production.

A variety of additional abuses have been identified by state and/or national laws and statutes as potential elements of illegal marketing plans or activities:

- *Products which have "no real world" marketplace,* i.e. the marketing program is a facade for a scam.
- *Products which are sold at inflated prices.*
- *Substantial cash investment requirements.* This is different from "Front-End Loading" as described above. Prohibited are:
 1. Payments in excess of the fair market value of the goods and/or services being purchased at the time of enrollment, and
 2. Excessive enrollment fees.
- *Mandatory purchases of peripheral or accessory products or services,* including educational or training materials and workshops, conferences, etc.

- *Plans in which Representatives are left with substantial unsold inventory upon cancellation of participation.* This is one of the bases for requiring companies to have a "buy-back policy.
 - *Earnings misrepresentations* (of existing or past members of the sales force) or inflated income potential representations.
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DETERMINANTS OF LEGALITY/LEGITIMACY

In determining whether a program is a legitimate Direct Sales opportunity, the would-be participant should consider several important points:

1. **Goods or Service.** *Legitimate companies offer high-quality goods or services and guarantee consumer satisfaction.* Goods and services must have a "real" demand in the marketplace, or an anticipated "real" demand if the good or service is just being introduced. Goods and services must have their own intrinsic value, such that Representatives who purchase them would do so even if they were not involved in a Direct Sales Business Opportunity.
2. **Price.** *Legitimate companies offer goods and services which are fairly and competitively priced.* This eliminates companies which would attempt to benefit by "price gouging" the members of their own sales force. It also ensures that Representatives do not make purchases or encourage others to do so solely in order to receive financial reward. Representatives must be able to purchase the company www.mlmlegal.com Product at wholesale or at a substantial discount from retail, based on volume of purchases
3. **Investment Requirement.** *Legitimate companies require no up-front investment.* Representatives who wish to participate in the Business Opportunity may be required to purchase sales kits or demonstration materials at or near company cost.
4. **Purchase and Inventory Requirement.** *Legitimate companies have neither minimum purchase requirements nor inventory requirements in order to become an Independent Representative.* Companies are restricted from requiring enrolling Representatives to purchase any amount of goods or services. Once in business, however, Representatives may be required to maintain or achieve company described minimum requirements in order to qualify to maintain or advance in sales force management status and retain or receive the associated privileges and benefits. These minimum requirements are usually based on personal purchases and sales, and the total Group Volume of sales and purchases generated by a Representative's P50.
5. **Product Use.** *Legitimate companies offer goods and services that people use.* Purchasers may have need for, or simply desire, these goods and services. Ongoing consumption by purchasers based on satisfaction with the good or service is one of the keys to success in any business.
6. **Sales Commissions.** *Legitimate companies pay sales commissions solely for goods and services purchased.* Commissions should not be paid on any sales materials, training fees, or any sort of non-Product sales. Commissions are fairly determined and spelled out succinctly in companies' Compensation Plans. Commission payment schedules are

previously determined, announced, and adhered to by companies. Companies pay out all commissions as specified within their total Compensation Plan.

7. **Buy-back Policy.** *Legitimate companies agree to buy back inventory and sales kit materials* — for some reasonable period of time — that are in resalable condition and are in the company's current catalog. This policy is especially directed at serving Representatives who cancel their participation and do not wish to use or resell their existing inventory at the time of their termination. This policy also benefits Representatives who purchase inventory in anticipation of making sales which then do not occur.
8. **Retail Sales.** *Legitimate companies place an emphasis on retail selling to non-participants.* Companies promote retail selling in many ways. They do so to encourage a wider use of their Product, and to have Representatives benefit by building a customer base from which they receive retail profit. This focus is also strengthened by various components of companies' Compensation Plans, which may include special contests or bonuses specifically aimed at increasing personal retail selling.

Many states have legally determined that purchases for personal consumption in reasonable amounts by Representatives and their families are equivalent to retail sales. Identifying "personal use" as equivalent to a retail sale is not yet universally accepted by courts and regulatory agencies. As previously noted, declaring this widely used Industry practice illegal could impair much of, if not the entire www.mlmlegal.com Direct Sales Industry. Therefore, legalization or regulatory validation of personal use as equivalent to a retail sale is one of the important priorities of the Industry and its trade associations.

9. **Independent Representative Activity.** *In legitimate companies, members of the sales force perform bona fide supervisory, distributive selling or soliciting functions* to move the Product to the consumer.
This translates into actively engaging in:
 - Retail selling,
 - Promoting the Business Opportunity, and/or
 - Managing — including communicating with, training, and supervising — the members of their PSO.
10. **Earnings Representations.** *Legitimate companies only make earnings representations that are based on actual, verifiable prior performance by members of their sales force.* Company literature can refer only to the actual performance of Representatives under the *current* Compensation Plan.

As with companies, Representatives are also responsible for making truthful earnings representations and representations of potential earnings which typically requires a disclosure of average earnings of company Representatives.

11. **Training.** *Legitimate companies offer solid training* to their Representatives, especially in the areas of selling and presenting the Business Opportunity. Training is often in the form of one or more of the following:
 - Print materials.
 - Audio and audio visual materials.

- One-on-one training by members of a Representative's Personal Upline — especially his or her Sponsor.
 - Company-sponsored events such as workshops and conferences.
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POSTAL SERVICE REGULATIONS WHICH AFFECT THE DIRECT SALES INDUSTRY

Until fairly recently, the U.S. Postal Service has been relatively uninvolved in the Direct Sales Industry — except of course by providing mail services. The Industry primarily relies on personal contact for presenting the Business Opportunity and selling Product. As it has expanded in size and scope, mail-driven campaigns have become an excellent source of recruitment and sales for Direct Sales companies and Representatives. The increase in mail-driven campaigns has produced increased monitoring by local postal inspectors, and has been responsible for an increased number of investigations triggered by inquiries to local postal offices by mail recipient

For years, postal inspectors have quite rightly www.mlmlegal.com chased illegal lottery schemes, chain letter schemes, blatant "boiler room" fraud operations and other scams. These illegal activities, however, are often (mis)represented by their perpetrators as legitimate Direct Sales companies or opportunities. This has resulted in some postal inspectors' confusion about what legal use of the mail for legitimate Direct Sales business purposes, and what constitutes mail fraud or business fraud perpetrated through the mail. Moreover, these distinctions have not been well examined or well defined by the general counsel's office of the U.S. Postal Service in Washington, D.C. Unfortunately, this confusion has resulted in some Postal Service administrative decisions which have led to enforcement activity unfairly directed at legitimate Direct Sales companies and Representatives who use the mail for legal purposes.

The U.S. Postal Service enforces two types of postal statutes.

1. *Mail fraud statutes prohibit soliciting and receiving money through the mail under false pretenses.*

Very often the culprit in a fraudulent mail solicitation makes statements such as: "Earn \$10,000 a month after your first week with minimal effort." Like most states' attorneys general, the U.S. Postal Service requires substantiation of earnings claims. Fraudulent earnings representations or Product misrepresentations by illegal companies or unethical individuals often draw the attention of postal authorities and trigger enforcement action.

2. *Postal lottery laws state that it is illegal to charge a consideration for the "chance" to win a prize using the U.S. mail.*

U.S. Postal lottery statutes have proven to be a nuisance to Direct Sales companies and Representatives. This statute is quite ambiguous and, when improperly exercised, can be used to ensnare even the best Direct Sales programs. Those attempting to enforce Postal

Service lottery laws upon Direct Sales companies base their assertion of illegality upon the question of whether the parent company requires that an upline Representative exert meaningful control and management over the members of his or her PSO — or whether a Representative's receipt of Override Commissions from sales made by the members of his or her PSO is based on chance.

Legitimate Direct Sales companies and Representatives accurately represent their goods, services, Business Opportunities, earnings and earnings potential in all interactions, whether in person, by mail, or by any other means. Practical approaches to successfully building a PSO of any size require interaction with and support of members of that organization. Their results are an indication of their Upline's experience, expertise, dedication, and direct or indirect training and supervision. By these criteria, legitimate companies and www.mlmlegal.com Representatives are the most likely to avoid prosecution under U.S. Postal laws. Unfortunately, as has been indicated, legitimate operation does not necessarily ensure that companies or Representatives who use the mail will not be prosecuted. But those who act within the confines of Industry *Codes of Ethics* — if brought to trial — should withstand this (unfortunate if not unnecessary) test. Unfortunately, there is extremely minimal case law on this issue.

THE FEDERAL SECURITIES AND EXCHANGE COMMISSION'S RULING THAT PYRAMIDS ARE SECURITIES

The SEC, federal and state law, and state regulatory agencies define Pyramid Schemes as "securities"- passive investment schemes. Such schemes are characterized as an investment of money with expectation of a return that is substantially caused by someone else (i.e. the "investor" is passive).

Investing in your own small business is not a passive investment because the profit comes solely or primarily from your own work. Similarly, purchasing a franchise is an active investment.

The purchase of a share of stock in IBM, however, is a passive investment. So is participating in a program which involves "headhunting" and/or Front-End Loading. In such illegal programs — which require no (or insufficient) sales of goods or services and are not Direct Sales programs, companies, or activities — participants expect to make a profit solely or primarily by being paid for recruiting new participants.

Whenever it appears that a Pyramid Scheme is masquerading as a Direct Sales opportunity, the SEC and other agencies take legal action. When the accused breach of legality is true, prosecution and conviction is a great service to the public and to Direct Sales companies. However, when prosecution of a legitimate Direct www.mlmlegal.com Sales company occurs, media sensationalism, legal costs, and other factors can cause the demise of a company and all of its sales force, and may add to tarnishing the public's perception of the Industry — even if the company is vindicated and cleared of all charges.

In 1971, the SEC announced that, in its opinion, an improperly operated Direct Sales company was, instead, a security. The agency's assertion was that any Direct Sales company in which Representatives were not adequately involved in sales, promotion, or management activities in fact or appearance acted like a Pyramid Scheme. Such companies were likened to and accused of being passive investment schemes.

The 1971 SEC notice is not an indictment of the whole Industry. Nonetheless, the SEC's willingness to vigorously challenge even legitimate companies has contributed to misperceptions and negative opinions about the Industry in the public, business, and legislative sectors.

Even so, the SEC has been instrumental in creating some of the legal distinctions between legitimate Direct Sales companies and activities and fraudulent or illegal companies and activities. One of its most substantial cases which has contributed to defining these differences was its prosecution of International Loan Network (ILN) in 1992.

ILN presented itself as a "consumer benefit service" which offered its members and distributors "opportunities" for real estate investment. The SEC argued that the program was driven by "the deal" and was therefore a headhunting scheme.

Potential ILN "recruits" were invited to emotionally charged revival-type meetings where they were encouraged to invest large amounts of money in "memberships" which were supposedly attached to high-return real estate investments. They were then told that the way to make a fortune was to get others to join and invest, too. Large amounts of money were invested with expectation of large returns — which never materialized.

ILN's operations also demonstrated several other infractions which have been discussed above, including:

- High initial investment.
- No tangible goods or service.
- No customer guarantee.
- No "fair market value" to the commodity.
- Commissions paid on enrollments rather than on the sale of goods or services.

The federal courts accepted the SEC position that the ILN marketing program constituted the sale of securities and was therefore an illegal Pyramid Scheme. In this case, the court compared the ILN program to some of the abuses in other programs, www.mlmllegal.com such as Dare to be Great, Koscot and "Challenge to America." All of these had been earlier successfully prosecuted as Pyramid Schemes and thus were judged to be illegal securities.

THE SEC's DISTINCTIONS

It is useful to contrast the ILN program with elements of legitimate companies. While many of these points are a reiteration of what has already been stated earlier in this Chapter, they are included here as indication that the various agencies that exert their influence on creating legislation which affects the Industry are somewhat in harmony.

According to the SEC and the court:

1. The driving force of the ILN program was "the deal" — soliciting recruits to invest large sums of money, and encouraging them to procure others to do the same.

The driving force of a legitimate Direct Sale company is its Product. The underlying philosophy of the ILN program was preached at what were called "President's Night" recruitment meetings: "The movement of money creates wealth. What we believe is that if you organize people and get money moving, it can actually create wealth."

Legitimate companies do not promote success through hype or "get rich quick" claims. The basics of Direct Sales — retail selling and creating and managing a PSO — can take time. But these activities can result in consistent — and consistently increasing — financial and other rewards.

2. The ILN program was characterized by the payment of headhunting fees for recruitment of new distributors. The court ruled that "the intent is for a person to become a member first and then recruit new members." It noted the oft-quoted game-like pitch of the ILN president: "You come in, then you bring your www.mlmlegal.com wife and your kids."
3. The court observed that the ILN membership had no real independent meaning outside the context of its marketing program. In essence, the only likely reason individuals invested in ILN was because of the perceived "Income Opportunity." ILN had no previous track record of marketing its memberships or real estate investments without the pyramid opportunity. The entire thrust of meetings and literature was to encourage people to invest and to "move money to make money."

Legitimate companies' Business Opportunities and Compensation Plans support the purchase and sale of goods and services. Building a PSO forwards this purpose.

4. The ILN program was replete with earnings hype through activities such as check waving and "money humming." The courts characterized its meetings as "evangelistic revival-type meetings... part motivation and part financial evangelism."

Legitimate companies tell the truth about earnings and earning potential, both of which can be verified in company records.

5. In the ILN program there was no actual retailing to any nonparticipant consumers.

Legitimate companies sell legitimate goods and services to their Representatives, who then use them or resell them to non-participant customers. Some Direct Sales companies allow non-participant retail purchases directly from the company, but most refer prospective retail customers to a Representative.

6. The "big money" to be made in ILN was in large investments in real estate.

The ILN real estate investment program was an adaptation of an earlier such program that even ILN officials admitted involved the sale of securities. The courts ruled that the ILN membership marketing program and real estate investment marketing program were a "single interlocking program," and that the real estate program was "inextricably intertwined" with the membership marketing program. Inducements to participants to invest large sums of money are characteristic of pyramid cases.

Legitimate companies do not require any financial investment. After purchasing a sales/training kit at or near company cost, Representatives primarily invest time in retailing goods or services to customers. Through www.mlmlegal.com various systems of order taking, many (if not most) Direct Sales companies are set up to support Representatives to not use their own money to purchase Product for existing orders. Two examples include:

- Customers pay the Representative at the time the customer places the order. These funds are then used by the Representative to pay the company for inventory to fulfill the customer's order, and
 - Customers order directly from the company by phone or mail and pay by credit card, check, or electronic checking account debit. The Representative is credited with the sale and receives the retail profit and commissions associated with it.
7. ILN distributors were encouraged to bring recruits to pep rallies where ILN officials "closed the deal." This element of "common enterprise" and "efforts of others" is typical of Pyramid Schemes.

In legitimate companies, there are no "pressure tactics." Group trainings, conventions, and similar activities are used to build a sense of community and increase Representatives' knowledge and skills. Sponsors and other members of a Representative's Personal Upline may assist in training him or her to learn the skills or be more successful at retail selling and creating and managing a P50, but ultimately the responsibility and the rewards belong to the individual.

These distinctions — as identified by the SEC, the U.S. Postal Service, national and state governmental agencies and justice systems, and states' attorneys generals — all lead to the conclusion that the Direct Sales Industry has a future, while Pyramid Schemes and other illegal scams do not. Legitimate companies will have a legally supportive environment within which to operate. Illegal activities by unscrupulous individuals will, in the foreseeable future, have far too many regulatory agencies and legal entities as adversaries to operate for any significant length of time.

PRACTICAL EFFECTS OF LEGISLATION AND THE LEGAL ENVIRONMENT ON THE INDUSTRY

Following are more in-depth presentations of the way existing laws and policies are affecting the Industry, along with some of the foreseeable trends

REFUNDS FOR MLM DISTRIBUTORS

All of the issues associated with operating Direct Sales companies have not been fully resolved. One of the issues that remains unresolved is that of refunds to Representatives. Currently, this issue is being addressed at four levels — within individual companies, by Industry associations, and by state and national legislators.

The Amway Safeguards Rule provided some basic operational principles that help to ensure a company's legitimacy. That Amway had a "buy-back" policy in place was influential in the courts ruling. Nonetheless, this ruling www.mlmllegal.com did not necessarily specify that Amway's specific buy-back policy was the only one that would withstand the test of legitimacy. The key elements of Industry buy-back policies generally include:

- That the Product (including training materials and goods for resale) be in resalable condition, including that the "use by" date be current for perishable goods such as vitamins.
- That the Product be among the companies current offerings
- The company's right to include a minimal "restocking fee" (usually 10% or less).
- A specified timeframe with which the Representative must return the Product after its initial purchase.

Buy-back policies' greatest impact is on Representatives who terminate their affiliations. These policies allow such Representatives to return their unused or unsold inventory to the company, ensuring that Representatives are not "stuck" with inventory they no longer want.

Throughout the Industry there are still a wide variety of buy-back policies and practices. For example, there is significant debate regarding the appropriate buy-back period, which ranges in existing policies between 30 days and as long as the company is in business. The trend, however, is definitely toward Industry wide adoption of buy-back policies and practices that fall within more limited parameters. Most of the exiting policies fall within ethical, if not legal, standards which protect Representatives' rights.

Some of the existing policies and practices, even among otherwise legally and ethically operating companies, are less supportive to Representatives. Some companies reduce the returned merchandise's refund value by the dollar amount of Upline Commissions previously paid on those items. That these practices even still exist has prompted increased attention to this issue by Industry associations and state legal authorities.

These practices are disappearing from the Industry. They are being replaced by other more supportive practices, such as companies "charging back" – or deducting from future payments – previously paid commissions to members of a Representative's Upline when merchandise is returned for a refund by a Downline Representative.

Member companies of the DSA determined that Industry self-regulation was a necessary step in demonstrating to legal authorities and the public the Industry's commitment to ethical operations that take into account Representatives' and consumers' rights and welfare in addition to that of companies. It was hoped that self-regulation would assist in creating practical changes that would lead to greater consistency, and help to address the criticism that Direct Sales companies were "hit and run" operations. Additionally, the Association hope that such self-regulation would send a message to regulators that the Industry could – and would – address its own problems, diminishing the need for excessive legal regulation.

Thus, the DSA has incorporated a buy-back www.mlmlegal.com policy for Representatives in its Industry *Code of Ethics*, by which member companies must agree to abide as a condition of acceptance and ongoing membership. The policy calls for buyback of inventory and sales aids in resalable condition for a period of 12 months from purchase at 90% of the net cost to the Representative. Upline commissions may not be deducted from the refund. Promotional items or goods with seasonal or short lives are not subject to buyback if companies disclose this fact to Representatives in advance.

Buy-back policies are meant to protect individuals who want to leave a business and believe they were mistaken in buying more inventory than could be sold. Within these parameters, buy-back policies do not apply to situations where the company can prove that Representatives are disposing their inventory merely to switch to another company or move whole groups of Representatives to a competitor. They also do not apply to Representatives who, for the purpose of qualifying for a bonus or some other benefit, have falsely certified that the inventory for which they are attempting to receive a refund has been previously sold.

The buy-back standards stated in its *Code* impact billions of dollars of annual sales and millions of participating Representatives in the DSA's current roster of hundreds of pending and full-fledged members.

The DSA and MLMIA have similar Industry *Codes of Ethics* which incorporate a Representative buy-back policy that member companies must agree to abide by as a condition of acceptance and ongoing membership. The World Federation of Direct Sales Associations — the international federation of Direct Sales trade associations — has a similar *Code* for its nearly 50 member nations.

The DSA's *Code of Ethics* has served as a benchmark in the development of state laws governing the legal operations of Direct Sales companies. The Association has, in many cases, had direct influence through its lobbying efforts on the content of such laws. States that currently have legislation which includes minimum standards for buy-back policies include Maryland, Massachusetts, Wyoming, Oklahoma, Texas, Louisiana, and Georgia. Puerto Rico also has such legislation. Other states will surely follow.

Industry self-regulation and state law — coupled with business practices that provide competitive benefits for Representatives and support their company loyalty — will most likely eventually create minimum buy-back standards Industry wide.

EARNINGS REPRESENTATIONS AND POTENTIAL EARNINGS REPRESENTATIONS

One of the most significant questions by someone reviewing a Direct Sales Business Opportunity is: "How much money can I make?" Legitimate companies and ethical Representatives always give answers which are truthful and verifiable. Prospective www.mlmllegal.com Representatives must be minimally able to accurately assess:

- The actual income of the highest producers.
- What the average or "typical" Representative makes.
- Under what circumstances what amounts and types of commissions and bonuses are earned.
- An estimation of the amount of work that is required to achieve specific results.

According to the DSA, in 1997 approximately only 13% of active Representatives devoted full time to their Direct Sales business. The remainder were "part-timers." Many Representatives use Direct Sales as a second source of income. "Full-timers" who do not use their skills and resources effectively and efficiently may do poorly; part-timers who are skilled and focused can do exceptionally well. For the vast majority of Representatives, however, their results are proportional to the amount of time they devote to Direct Sales activities.

The Direct Sales Industry, unlike many others, is one in which individuals can make virtually unlimited incomes. In most companies which have been in existence longer than six months there are at least a small number of Representatives who earn more than \$25,000 per month. For these people, their level of income is the result of hard work, talent and good fortune.

Industry insiders often refer to six categories of income earners in the Industry. These categories are by no means "Industry standards." While relatively arbitrary, they seem to hold up to the test of observation:

1. *Consumers who enroll as Representatives solely for the right to purchase goods and services for their own use at wholesale cost.* These Representatives are not active in any selling, promoting, or managing activities.
2. *Consumers who want to receive their goods or services for "free."* These Representatives do only a minimum amount of retail selling and/or managing a few members of a Personal Downline — solely for the purpose of earning enough profit to cover the cost of their personal purchases.
3. *Income Earners who wish to make a profit of up to \$200 per month in excess of the cost of their personal purchases.*
4. *Income Earners who wish to make a profit of between \$200 and \$500 per month in excess of the cost of their personal purchases.*
5. *Income Earners who wish to make a profit of between \$500 and \$2,000 per month in excess of the cost of their personal purchases.*
6. *"Major Earners"— who wish to create incomes greater than \$2,000 per month.* These Representatives are "Industry professionals." Major Earners learn to use Direct Sales compensation systems to their fullest advantage, and often earn in excess of \$30,000 or

\$40,000 per month. Some of the Industry's top earners post incomes in excess of \$100,000 per month.

Direct Sales companies are not required to file earnings information with any governmental agencies. Most state and federal laws severely restrict what can be stated in company promotional and training materials about earnings and possible earnings.

Companies may, of course, publish and explain the functioning of their Compensation Plan. Earlier promotional practices often included a www.mlmlegal.com Representative or company promotional materials "spinning the numbers" to prospects, using hypothetical cases to present optimal earnings potentials. This practice, as previously mentioned, is now restricted. It has been replaced by presentations in which prospective Representatives are encouraged to determine the amount of time and effort they would like to dedicate to Direct Sales activities, and what results they think they'll produce from those efforts. Then prospects "fill in the blanks" on an earnings worksheet to produce their own income projections. This practice appears less contestable, as it provides a clearer picture that actual earnings will either be less or more according to prospects' actual efforts and performance.

Prospective Representatives often turn to current Representatives as a source for earnings information. Properly trained Representatives know what they can and can't say about earnings and projected earnings when speaking about the company in general. They know sources for this information, and can inform prospects how to verify it. Since an important role of a Sponsor is to act as a model, potential Sponsors benefit by being forthright about:

- How long they have been affiliated with a company.
- How long they have been in the Industry (if they have worked in other companies).
- How much they currently earn.
- What efforts were necessary to achieve their earnings.

Many laws and regulations are very prohibitive with regards to the information a company is allowed to publish about earnings and earnings potentials. For instance, several states have adopted legislation to specifically prohibit companies from making any earnings projections based on hypothetical or theoretical possibilities. These and other laws restrict companies to publishing earnings figures only for their currently active Representatives, or conversely prohibit companies from presenting earnings of Representatives who are no longer active in the company.

California legal authorities, for example, have pursued a number of companies with respect to earnings misrepresentations. The State of California particularly objects to any inflated earnings representations and finds practices which can be categorized as "check waving" to be deceptive and misleading. Most company-issued checks show only gross earnings. They are therefore not accurate representations of a Representative's net earnings after accounting for costs associated with running his or her business, which may include:

- Purchases for inventory.
- Rebates or commissions the Representative may have personally paid as incentive or reward to other members of his or her PSO.

- Operating expenses such as telephone, mailing, transportation, rent, utilities, etc.

Ethical Representatives report both their gross and net incomes, and inform prospects of the expenses which account for the difference.

California has also prosecuted companies after receiving reports that Representatives had misrepresented the ease with which others could be promoted into the Business Opportunity.

In Texas, "pie in the sky" earnings claims have been referred to by the attorney general's office as "airborne pastry." As in other states with legislation which can be applied to Direct Sales companies and activities, there is minimal guidance in the statute books as to the line between legal and illegal practices related to income earnings and potentials. In practice, Texas prohibits companies from making earnings projections, but allows greater leeway with regards to Representatives' testimonials.

Perhaps the state which has been most active in this area is Wisconsin, which pursued Amway on this particular point. The Wisconsin attorney general's office reviews companies to determine whether income representations reflect the www.mlmllegal.com actual earnings of current participants and are accompanied by "affirmative disclosures" which place such representations in context. Affirmative disclosures can include the time frame on which the representation is based and an indication of the percentage of Representatives who actually achieved a particular income level.

The attorney general's office based its case against Amway on the company's (and its Representatives') purported use of income representations which:

- Did not accurately portray the income experience of persons who had participated in the business under the current Compensation Plan, and
- Did not indicate the percentage of Representatives who had actually achieved the earnings levels being used as illustrations, stating that these were violations of Wisconsin's trade practices law.

The Wisconsin attorney general obtained a consent agreement with Amway Corporation requiring the firm to disclose actual sales, income or profit experiences of active Representatives in conjunction with the use of hypothetical income examples. The agreement required Amway to disclose the percentage of Representatives who actually had achieved any level of performance which was being used for illustrative purposes. Amway was further required to disclose the percentage of active Representatives versus those who had become inactive.

At the national level, the FTC has vigorously enforced restrictions on earnings claims. From the FTC's standpoint, making any earnings representation is a "deceptive trade practice" unless it is accompanied by a simultaneous disclosure of Representatives' average earnings and the percentage of Representatives who achieve various earnings levels.

The guidelines which appear to be emerging from the combination of existing states' and national statutes and regulations is that Representatives can legally give earnings testimonials in which they indicate:

- How long they have been in the program.
- What specific geographic area they have had success in building their PSO.
- The amount of time and effort, and the resources it has taken to achieve their results.
- An accurate representation of their current or historical net earnings, which may include a disclosure of their gross earnings and the costs of running their business.

However, when a Representative or company www.mlmllegal.com makes an earnings representation, they should also provide company statistics which demonstrate:

- Income earnings only of current active Representatives, under the existing Compensation Plan, and
- The percentage of Representatives who actually achieve any earnings level used for illustrative purposes.

PERSONAL USE - THE ONCE AND FUTURE ISSUE

Throughout the recent history of the Direct Sales Industry there has I been tension between the Industry and the regulatory community as to the legal status of the "personal use" of goods and services by Representatives. The broad and ambiguous language in pyramid legislation has contributed to this problem. Pyramid statutes require that commission payments be based upon the "sale of goods or services." But they stop short of defining to whom those goods or services must be sold in order for a company to avoid being classified as a pyramid.

Almost all major Direct Sales companies have defined "retail sales" as including sales to their Representatives for their own personal use or consumption as well as to non-Representative retail customers. Many regulatory officials, however, have maintained that "legitimacy" requires that, a company's primary sales revenue come from sales to non-Representatives.

In the earliest days of the modern Direct Sales era, virtually all sales by companies and Representatives were to non-participant retail customers. Since the introduction of Multi-Level Compensation Plans (MLCPs) and Network Compensation Plans (NCPs) in the mid-1940s, however, the emphasis has shifted dramatically. Many, if not most, Direct Sales companies with MLCPs and NCPs not only encourage, but are based on the primary personal use of the company's Product by Representatives. Of course, these companies also encourage retails sales, but usually emphasize retail selling more to those who want to "build their business." Many of the Representatives in such programs have enrolled solely as wholesale customers. These companies would be dramatically affected if legal restrictions required retail sales to non-participants as the primary income source.

As a theoretical goal, the regulatory position is admirable. The fact is, however, that personal use in the Industry has been a major factor in sales revenue for many Direct Sales companies from their inception.

For many years after the 1979 Amway decision, a "live and let live attitude" prevailed between the Industry and regulatory community. Although periodic legal skirmishes occurred, the Industry and regulatory community appeared to be content to "agree to disagree" Instead, the focus of legal investigations was upon Inventory Loading, cash pyramids, phony products and earnings hype.

The comments of a federal appeals court in 1996 class action case involving a company called Omnitrition invigorated the debate. In that decision — which involved an interim ruling in the case — the federal appeals court questioned www.mlmlegal.com whether or not a Direct Sales company could be viewed as legitimate if its sales were not derived from non-participant customers. The language in the decision was much criticized by the Industry. The DSA, in fact, filed an amicus brief requesting the court to reconsider its reasoning. This brief cited the importance of personal use in Direct Sales marketing programs. However, the decision stood.

In the aftermath of the decision, both state and federal regulatory agencies were emboldened to sue or obtain consent decrees against Direct Sales companies. These decrees contain very restrictive requirements regarding recognition of personal use by Representatives. State agencies were not at all in harmony with one another on their positions. Some demanded 50% sales to non-Representatives. Others demanded 70%, while still others demanded 80%. Even the FTC awakened after 20 years of dormancy and demanded, in various consent decrees, that more than 50% of sales be to non-Representatives.

The aggressiveness of government activity was alarming to the Industry. It quickly marshaled forces and, in short order, at least four states adopted legislation specifically recognizing personal use as a legitimate end destination for Product. Other states were likewise targeted for such legislation. The Industry was of the belief that a trend would be started that would ultimately be recognized by all state and federal regulatory agencies. In response to such strong sentiment, the Industry's leading trade association – the Direct Selling Association – undertook consideration of a formal amendment to its Industry *Code of Ethics* which would recognize that in legitimate Direct Sales companies, retail sales include sales to non-participants, as well as sales for actual use or consumption. One of the purposes of this amendment was create a more well-defined distinction between legal Direct Sales activities and Pyramid Schemes or other illegal "games of chance."

Notwithstanding the ongoing debate on "personal use," the Industry seems to thrive in almost all states. There is no question, however, that "personal use" is a thorny issue, and one upon which the Industry and regulatory community must carry on an earnest ongoing dialog in order to reach a consensus that protects consumers, Representatives and Direct Sales companies.

CONCLUSION

One cannot study the history nor operation of the Direct Sales Industry without appreciating the importance of legal issues. Time and again the Industry has appeared to successfully rise to legal challenges to its legitimate companies and practices. In some cases, such as the Amway/FTC case, the Industry prevailed in litigation. In many www.mlmlegal.com instance however, it has addressed legal issues by adopting self-regulating rules for example on issues such as refunds and earnings representations. Addressing legal issues is a dynamic task. It is clear that the future will demand continuing attention to important legal matters that have wide- ranging impact on Direct Sales businesses.

On any given day you can catch Jeffrey Babener, editor of 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 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