

New York v. Phase II

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New York v. Phase II

Case: New York v. Phase II (1981)

Subject Category: Pyramid

Agency Involved: New York Attorney General

Court: Supreme Court, New York County

New York

Case Synopsis: Phase II operated a referral sales program. The New York Attorney General sued to enjoin the program, claiming that it was an illegal chain referral program.

Legal Issue: Was Phase II an illegal chain referral program?

Court Ruling: The Court held that Phase II was a chain referral program in violation of state statute and that its activities should be enjoined because of a substantial likelihood of future harm. Phase II sold cosmetics through a MLM structure. Distributors made a commission based on their sale of products to downline distributors, and to the general public. A recruitment bonus and associated commissions were paid for every new recruit that a distributor signed up. The Court reasoned that because recruitment bonuses and commissions were paid on the signing up of a downline distributor, not on the sale of

actual product by that distributor, and that it was possible to make money just by bringing in additional distributors, the program met the statutory definition of a chain referral sales program and was illegal. An injunction preventing the company from operating was appropriate because the Attorney General had shown a likelihood of success on the merits and a probability of future harm.

Practical Importance to Business of MLM/Direct Sales/Direct Selling/Network Marketing/Party Plan/Multilevel Marketing: To avoid many state pyramid statutes, commissions should not be based solely on the recruitment of additional distributors.

New York v. Phase II, 109 Misc.2d 598 (1981) : The Court held that Phase II was a chain referral program in violation of state statute and that its activities should be enjoined because of a substantial likelihood of future harm. Phase II sold cosmetics through a MLM structure. Distributors made a commission based on their sale of products to downline distributors, and to the general public. A recruitment bonus and associated commissions were paid for every new recruit that a distributor signed up. The Court reasoned that because recruitment bonuses and commissions were paid on the signing up of a downline distributor, not on the sale of actual product by that distributor, and that it was possible to make money just by bringing in additional distributors, the program met the statutory definition of a chain referral sales program and was illegal. An injunction preventing the company from operating was appropriate because the Attorney General had shown a likelihood of success on the merits and a probability of future harm.

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109 Misc.2d 598 (1981)

State of New York, Plaintiff,

v.

Phase II Systems, Inc., et al., Defendants.

Supreme Court, Special Term, New York County.

May 13, 1981

Robert Abrams, Attorney-General (*David L. Crawford* of counsel), for plaintiff. *Jonathan G. Jacobson* for defendants.

EDWARD J. GREENFIELD, J.

Plaintiff, State of New York, by the Attorney-General seeks an order enjoining defendants from operating a pyramid scheme and from distributing any funds obtained from the foregoing "fraudulent practices."

Defendants allege that they are in the business of selling cosmetics. They have an elaborate marketing plan described both in the plaintiff's and defendants' papers. Plaintiff characterizes the plan as one in which the emphasis is on recruiting new people to the company's organization rather than sales.

Defendant describes the organization as one of a series of steps in which the new "start", having sold a sufficient amount of the product, moves up in levels of the organization getting progressively higher percentages of the sales. At the maximum step, a "Gold Leader" receives 40% of retail sales plus 23% of wholesale product sales for which he is responsible either through his own sales or those of his recruits.

[109 Misc.2d 599]

While plaintiff's papers are noticeably lacking in the absence of affidavits of inspectors with first-hand knowledge of defendants' operations, the description of the operations of Phase II Systems, Inc. by both plaintiff and defendants is one that would lead the court to believe that the defendants are operating a chain distributor scheme.

Section 359-fff of the General Business Law provides in part that "'a chain distributor scheme' is a sales device whereby a person, upon condition that he makes an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition." An investment can be a purchase of property.

The mechanics of this scheme are substantially the same as the classic pyramid scheme except that one can join the organization for \$18 and become a "member" and then receive a 10% commission on all sales. While defendant speaks of "actual retail sales", it defines a retail sale to include sales or purchases to members and salespersons. When a member buys \$333 worth of products, he or she becomes a salesperson who then gets a 25% commission. Thus, the net investment to the salesperson is \$276 (\$333 less 25% plus \$18). The person who brings in a new salesperson gets a \$50 bonus. If a salesperson can bring in eight new recruits as salespersons in a calendar month, he becomes a distributor and then in addition to getting \$50 for each he gets an additional 15% on all sales purchases by the new salespersons. The formula gets more complicated as the distributor continues to recruit new salesmen and progresses from distributor to silver level to the top or gold level. The Attorney-General has calculated that while an original salesperson needs to recruit only 32 persons to achieve the gold level, in order for those recruited in the fifth generation, an additional 167,772,154 persons will have to be recruited (initially ordering in excess of \$55 billion worth of products).

Effectively, then, sales of products to nonmembers or nonsalespersons is unnecessary since members or salespersons

[109 Misc.2d 600]

can make money just by bringing into the organization new people willing to become a salesperson.

There is sufficient indication herein that defendants are participating in a scheme where the emphasis is not on the sale of a product, but on recruiting new organizational rows to boost existing members. (See *Securities & Exch. Comm. v Turner Enterprises*, [474 F.2d 476](#).)

Pursuant to section 359-fff of the General Business Law, such a scheme is illegal. An illegal business transaction can be enjoined pursuant to subdivision 12 of section 63 of the Executive Law.

Plaintiff has established the likelihood of success on the merits and the danger of irreparable harm to the public (see *State of New York v Kozak*, [91 Misc.2d 394](#)).

In addition, it should be noted that the Attorney-General in his third cause of action, alleges that defendant, a Nevada corporation, is not authorized to do business in this State pursuant to sections 1301 and 1304 of the Business Corporation Law. Defendant upon this motion does not address this allegation and thus upon this ground the injunction could be issued (Business Corporation Law, § 1303).

Accordingly, the motion is granted.

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