

Ethical Issues Connected with Multi-Level Marketing Schemes

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ABSTRACT. Multi-level marketing (MLM) schemes are one of the fastest growing types of business. However, little has been written about the ethics of MLMs. This oversight is somewhat surprising, especially because some prominent MLMs have been accused of being pyramid schemes. Pyramid schemes were the number one type of internet fraud in 1996, and the fourth most common form of internet fraud in 1997 (National Consumers League, 1997). This paper examines the nature of MLMs and their similarities with and differences from pyramid and endless chain schemes. The paper argues that MLMs pose some unique ethical issues, issues that are not easy to address or resolve.

What is multi-level marketing?

Multi-level marketing, also known as network marketing, refers to the practice of distributing, selling or supplying products or services through various levels of independent agents (contractors, distributors, etc.). These agents are paid commissions, bonuses, discounts, dividends or other forms of consideration in return for selling products or services and/or for recruiting other agents. The party who recruits another participant is the "upline" of the recruit. The recruited party is the "downline" of the recruiter. In MLMs, uplines are paid bonuses or commissions on the sales made by their direct downlines and

by those who are downline of these direct downlines.

A company using this type of marketing is a MLM company. The MLM company may be an individual, firm, corporation or other type of business entity. Avon, Amway, Equinox International, Mary Kay, NuSkin and Tupperware are all MLMs. MLMs may be legal or illegal. MLMs become both illegal and unethical if they operate as "pyramid" or "endless-chain" schemes (Reese, 1996).

What are pyramid and endless-chain schemes and why are they unethical?

Pyramid or endless-chain distributor schemes ask people to make an investment and, in return, grant them a license to recruit others who, in turn, recruit still others into the scheme. In essence, the investor pays for the opportunity to receive compensation when his or her recruit brings others into the scheme. The opportunity to recruit is the product.

Such schemes are illegal because they are unethical in two respects. They are (1) fraudulent, and they are (2) recruitment-, rather than product-, centered businesses. Pyramid schemes are fraudulent because they typically promise a large return in return for a small investment. Those who join a pyramid scheme early often do make a great deal of money. Those who come in later, however, make little or even lose money because there simply are not enough remaining people left to recruit into the network.

Consider chain letters, a version of an endless-chain scheme. Chain letters contain a list of people. Upon receipt of a chain letter, the

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recipient is to send something (money, postcard, an email message) to the person at the top of the list. The recipient then removes the top person and puts his own name at the bottom of the list. In the famous David Rhodes electronic chain letter, the list consisted of ten people. Recipients were told to send money to the person at the top of the list and to forward the letter to ten bulletin boards. Those who participated would receive money once they reached position 5 on the list (Watrous, posted as of 1999). But how many people would need to be involved before a participant would receive any money?

The scheme looks like this:

Copies in generation	Participant's position
10	–
100	10
1 000	9
10 000	8
100 000	7
1 000 000	6
10 000 000	5

The participant does not have any position in the first generation of letters because she does not get on the list until she, in turn, sends the letter on to ten people. As the schematic shows, the participant does not make any money until ten million electronic bulletin boards have been drawn into the scheme. There are not that many bulletin boards in existence! And, as others, have pointed out, even if one substitutes people for bulletin boards, one quickly runs out of participants (Watrous, posted as of 1999). The entire US population would be exhausted before the letter went through even another two generations. And, of course, this scenario is wildly optimistic, given that it is unlikely that even ten million people, much less the entire US population, would participate in the chain letter scheme. Those in the early generations may make some money, but the scheme begins to collapse as it develops. Later recruits find there are few people left to draw into the scheme.

Insofar as endless-chain or pyramid schemes entice persons to participate by promising them

that they can make large sums of money or gain some other consideration by joining and by getting other people to join, the schemes are frauds. Those who devise the schemes do not disclose how few people will make money. Instead, they play on the fact that many people do not understand geometric progressions (Watrous, posted as of 1999).

Ponzi schemes, also illegal, resemble chain letters. Here is how Luigi Ponzi worked his investment scam, a scam that has since been imitated by many:

Ponzi put up \$150 dollars and got ten friends to do the same. He promised his friends a 50% return on their "investment" in 90 days. He then got a second set of friends, many times larger than the first, to put up similar amounts and promised them the same "return on investment" that he had promised the original group of "investors." With the money he collected from the second set of "investors," he paid the first set back their \$150 dollars plus the promised 50% "return" (\$75 dollars). Naturally, the original investors were thrilled and enthusiastically began promoting the scheme. The process was quickly repeated with the second set of "investors" – and rapidly mushroomed from there. The intrigue was simplicity itself: give Ponzi money and in 90 days (and usually much sooner than that) he would give you your money back plus 50%, plus 10% to the recruiter. There was only one problem with the scheme: while the originators and early participants were handsomely paid off from the cash flow of those they recruited, the last ones who were brought into the scheme found that there was no one left to be recruited, and the cash flow stopped – leaving them "holding the bag" (Shearer, 1999).

The similarity between endless chain, pyramid and Ponzi schemes is obvious: in all cases, people are enticed into making an investment of money and time by a false promise of returns that become increasingly unsustainable as more people are drawn into the scheme. Nor does the situation materially change if a product (e.g., gold shares, jewelry) is introduced to make the scheme appear more legitimate (Reese, 1996). People may be told, for example, that they can make large sums of money if they buy jewels and if they pay a fee to recruit others to buy jewels.

As long as the returns come primarily from recruiting new people to make "investments" in jewels and in fees giving them the privilege to do recruiting, the scheme remains fraudulent. At some point, one will run out of people whom one can recruit to join the scheme.

These last comments bring me to the second reason why pyramid, Ponzi and endless chain schemes are unethical: it is not in the public interest to have businesses that are recruitment-, rather than product-, centered. The goals a company or organization sets for itself are constrained by what the public takes to be in its interest. We can point to two general principles governing which corporate purposes are ethically legitimate. First, a company's primary focus should be on the marketing of non-harmful products (i.e., goods and services) to consumers. It is not in the public interest to encourage corporations to concentrate on making money *per se*. Money can be made in all sorts of ways, some of which are exploitative. For example, a company might reap huge returns by producing and distributing child pornography. However, since child pornography is not a product in the public interest, the government rightly does not allow child pornographers to incorporate, regardless of how lucrative such a business might be.

Second, a corporation's focus should be on growing through developing the market for their non-harmful products, not on growth *per se*. Like profit-making, growth can occur in a variety of ways, some of which are inconsistent with the public interest. For example, an enterprise might grow through intimidation. People might become members of an organization because they fear for their lives if they do not join the enterprise. Clearly the practice of growing the business in and of itself does not make for ethically good business. It matters how the growth is occurring.

Taken together, these two caveats imply that ethically good, for-profit companies expand by finding and marketing non-harmful (i.e., non-dangerous, non-addictive, etc.) products that consumers want and by then increasing the number of customers for a given product and/or by developing additional non-harmful products that consumers will purchase.

In order, then, to ascertain whether a for-profit business is ethically good or not, we need to examine whether the business aims at making profits through developing/offering/marketing non-harmful products and aims at growing through enlarging the consumer base for these products and by offering new non-harmful products. We can think of such ethically good for-profit companies as "non-harmful product-centered" (Henceforth, I shall use the shorter phrase "product-centered"). For-profit companies that are not product-centered deserve close ethical scrutiny.

There are several practices or behaviors that indicate that a company and its agents are not product-centered but are rather recruitment-centered schemes – i.e., schemes promising participants easy money to be paid out of the investments of other participants instead of legitimate sales revenue. These behaviors include, but are not limited to:

- a. Focussing on growth through the recruitment of people instead of on sales of a non-harmful product;
- b. Requiring substantial upfront fees from those people who are recruited to sell the product;
- c. Pressuring recruits to purchase corporate products for their own consumption or to stockpile large amounts of inventory.

Pyramid and endless chain schemes typically use these tactics. Insofar as they are recruitment-centered, they are not in the public interest and, therefore, are unethical.

Legal and ethical MLMs

Since a MLM operates by recruiting a network of salespeople, this type of corporation easily can degenerate into unethical, fraudulent, recruitment-centered pyramid schemes. The courts are well aware of this problem and have imposed certain tests to distinguish between legal, non-fraudulent MLMs and illegal pyramid of endless chain schemes. In general, MLMs must do the following to be legitimate:

1. Monitor performance of independent agents to ensure that they really are making retail sales.
2. Have buy-back policies in place so that independent contractors do not get stuck with excess product.
3. Charge low upfront-fees for the right to market the MLM product.
4. Make purchases of sales training materials completely voluntary.

Are these standards, though, sufficient to ensure that a MLM is truly operating ethically? In the remainder of this paper, I will examine each of these policies in some detail and then identify several additional problems with MLMs, problems not addressed by the above standards.

Retail selling

As I noted above, ethical companies are product-centered. They do not make the recruitment of people into a pyramid-like structure their main focus. These ethical companies have retail sales to *end-consumers*. I would argue that it is not sufficient to have retail sales simply to one's own sales force. When sales personnel are the main consumers of a company's products, the suspicion grows that the uplines in the company are pressuring downlines to buy more goods in order to reach a higher level. MLMs typically identify various levels of performance – Pearl, Diamond, Manager, Supervisor, etc. Agents make greater money as they advance to higher levels because they become eligible for new types or levels of commissions. Since the uplines get bonuses, commissions, etc. on the purchases made by downlines, MLMs are quite susceptible to this kind of internal pressure. To be ethical, a MLM needs to do more than merely claim that it has retail sales. It needs to monitor its sales by requiring the sales force to document sales to end-users as opposed to sales made to other members of the sales force or purchases made for self-consumption. Furthermore, the MLM needs to tie rewards to *documented* retail sales to end-users.

Self-consumption is problematic not merely

because it often signals a pyramid fraud but also because many of those drawn into MLM schemes are desperate for a job. Such people may not be well-educated and may have little disposable income. Some MLM products are relatively expensive compared to generic goods on the market. Requiring the sales force to purchase pricey products in order to retain status as an "active" distributor begins to look like a form of coercion applied to people who are not in a strong position to resist the pressure. Many participants have spent thousands of dollars buying the products from MLMs that supposedly were providing them with lucrative "business opportunities" (Mills, 1996).

Inventory buyback

MLMs should commit to buy back inventory so that distributors have a viable right of exit. Participants need to be able to recoup some of the money they spent to acquire inventory that they have not been able to sell. Such a policy, like a policy of monitoring retail sales to end users, provides some protection to the MLM sales force. However, once again, simply having a policy does not suffice to make the company ethical.

In the first place, a buyback policy will be meaningless unless the company makes distributors aware of the policy. Second, for the refund policy to afford true protection to distributors, the distributors must get most of their money back relatively easily. If distributors must persuade their uplines to buyback the inventory, or if the upline is allowed to set the return price, distributors remain at risk. If the upline sponsor offers a low price (say 5 cents on the dollar), and if the distributor has no recourse to headquarters, then the distributor has no viable protection. Uplines have no incentive to offer downlines a fair price because the uplines have been paid bonuses on the inventory stockpiled by their downlines. Therefore, headquarters needs to guarantee some minimum fair price for returned goods. The industry (and legal) standard buyback price appears to be 90% of original value less any processing costs and any bonuses the distributor

received for the original purchase (Reese, 1996). Headquarters should commit as well to buying back goods at this minimum price in the event the uplines do not offer a price the downlines consider just.

An ethical MLM will take steps to ensure that returning inventory is easy. That means, in part, that the MLM will (1) publish clear guidelines for return; and (2) not play games designed to discourage inventory return. I know of one distributor who was told she needed to file a certain form in order to obtain a refund. She asked her uplines for the form, but they denied even knowing of its existence. She was bounced from distributor to distributor. Each party claimed that someone else had the requisite form. Still later she was informed that the MLM did have the form, but the company had run out of them and would not have them again for awhile. Such delaying tactics are ethically unacceptable.

It is important for MLMs to make it financially easy for distributors to leave the network precisely because participants in MLMs so often find it psychologically difficult to exit. MLM distributors typically depend heavily upon their uplines who have served as mentors and coaches. These uplines will counsel disgruntled downlines to stick with the program because uplines make money through the sales, product purchases, and recruiting efforts of downlines. Distributors may lose perspective – they no longer perceive the larger world that exists outside of MLM – and their sales pitch may well have alienated them from friends or relatives who might have helped them. Ex-distributor Stephen Butterfield poignantly describes the growing alienation he experienced while working Amway:

In each case, friendship was limited only to what I could use to accomplish my goal. The justification given by Amway would be that in order to realize my Dream I must help the prospect realize his. But his Dream had to cost money, otherwise it would not be useful. And I had to play that Dream like a fishline, specifically to bring the prospect to my group. If he could realize his Dream by selling T-shirts or ski hats, I would make no profit on him and our Dream building association quickly evaporated. In the end, prospecting was more alienating than loneliness.

Upfront fees & sales materials

The courts have looked askance at MLMs that charge substantial upfront fees for the privilege of joining the company and of recruiting other people. If a company is making most of its money from the upfront fees, then the suspicion arises that the company is recruitment-centered rather than a genuine retail sales organization. If a significant portion of a company's earnings come from an upfront fee or a sales kit or from training materials that new recruits are pressured to buy, an ethical red flag should go up.

But when is a fee substantial? Each case must be examined individually. If an individual is buying a franchise, then a fee in the thousands or even millions might be appropriate. Much will depend on the extent of opportunity and the amount of support, expertise, etc. provided by the company offering the franchise. In the case of MLMs, however, the distributor may receive little more than a company handbook and a few product samples when she joins the company. In these cases, even \$100 might be too much. We have to evaluate what the distributor is receiving in return for the fee. Once again context matters. A sales kit fee of \$100 might be moderate by U.S. standards but charging this same fee to distributors in lesser developed countries is another matter. \$100 could be the equivalent of three months' salary in some countries.

MLMs ought to monitor the accounts of uplines to insure that uplines are not pricing introductory sales kit at a rate higher than the official rate sanctioned by the parent company. In addition, MLMs should permit recruits to return sales kits as well an unsold inventory. By providing for sales kit returns, the company allows new recruits, who may have second thoughts about participating in the MLM, to leave without penalty. Such a policy works a bit like a cooling-off period in which consumers may return purchases without penalty within a certain period of time.

Finally, we need to be careful to specify what we mean by an upfront fee. A company may charge a relatively low fee for a starter kit, but then pressure new recruits to use the MLM's

phone service, to rent space at the MLM's office, and to purchase large quantities of sales aids or high-priced motivation tools (Federal Trade Commission, 1999). These costs, presented as necessary in order to succeed in business, should be counted as part of the upfront fee. If they are included, and if the fee is high, then we may be justified in concluding that the MLM is an unethical recruitment-centered pyramid scheme. In addition to the above problems, there are some dimensions of MLM selling that are perhaps inherently ethically problematic. These problems are not so easy to address.

Selling to family members and friends

Some MLMs encourage participants to sell product to family members and friends and/or to recruit them into the MLM. This marketing strategy poses certain ethical difficulties. Participants, desperate to succeed at their new MLM business, may feel driven to pressure relatives and friends into buying cosmetics, water filters, jewelry, etc. In other words, MLMs can alter human relationships, encouraging people to "instrumentalize" relations rooted in love and affection. Relatives may feel somewhat forced into buying goods in order to keep their sons or daughters from feeling ashamed, to show support or to avoid a big fight within the family. Such customers may not like the goods they buy, or the goods may prove defective. In normal circumstances, they would return the product to the store for a refund. But, in this case, purchasers may opt to swallow the loss, instead of confronting a beloved child or friend and demanding their money back. The products may come with a "money-back" guarantee, but the guarantee may not be meaningful in this context. Will people be likely to invoke the guarantee if doing so threatens family unity or long-term friendships? To be ethical, a MLM would have to warn recruits of the dangers implicit in instrumentalizing personal relations. Yet MLMs can hardly do so, given the realities faced by recruits. These new recruits likely have few sales skills or connections and probably do not know how to develop a market strategy. Who will the recruits

approach if they do not try to sell to those they already know?

Exploiting the host-guest relationship

A related concern: MLM participants typically pitch their products inside potential customers' homes. If you invite the Avon lady (whom you may know personally) into your home, you naturally will feel that you need to be a good host. You should be polite. Perhaps you will feel that you should feed the "guest." Of course, this guest is not your usual guest. A "guest" does not come into your house and then try to sell you something. The guest receives; she does not take. MLMs blur the line between the social setting and the selling setup. What the guest wants to receive is the host's order for product and money and/or a commitment to join the MLM. Since the host is accustomed to being responsive, this situation easily can be exploited by the MLM participant. This possibility, though, is not one that MLMs either warn about or guard against. On the contrary, MLMs advocate getting inside people's homes in order to make the sale.

Given that the MLM sales force is going into people's homes, MLMs have a responsibility to screen their sales force. In one case, a MLM salesman was a convicted rapist who assaulted a customer. Just as school districts must do background checks on busdrivers or others who have contact with children, so, too, an ethical MLM will do some monitoring of its independent contractors. While there may be limits on what the MLM should be expected to do in the way of vetting its sales force, surely the MLM ought to inquire as to whether its recruits have a criminal history, have been sued, etc. MLMs who have joined the Direct Selling Association agree not to hide behind the "independent contractor" status of their sales forces in an effort to avoid responsibility for what their sales force does (Direct Selling Association Code of Ethics, posted as of 1999). In this case, the sales force gains access to people's homes by citing the MLM's corporate name and by pitching that company's products. The MLM has some responsibility, therefore, for what its representatives do

once they have gained entry into customers' homes. As far as I can determine, though, few MLMs take even rudimentary steps to vet their sales force (Cornell, 1996).

Exploiting the professional-client relationship

Since MLMs recruit by advertising for people who wish to make money in their spare time, some professionals – e.g., dentists, lawyers and doctors – have joined MLM networks. For example, doctors have been selling vitamin and non-prescription health products offered by MLMs in their offices (Gianelli, 1999). Such a practice is problematic on several scores. The doctor owes a primary duty to the patient. But if the doctor is in business seeking to maximize his income, he may have a conflict of interest. On the one hand, he wants to persuade the patient to use a product. On the other hand, the patient may not really need this product, may be able to buy it cheaper (e.g., generic vitamins) elsewhere, or might be better served by a prescription drug. Furthermore, patients who are physically weak or confused are not in a good position to either evaluate or resist a sales pitch from their caretaker. Physicians in MLMs may take advantage of patients' infirmities.

The professional-client relationship is based on trust (Koehn, 1994). If the client begins to think the professional is putting his interests before hers, trust is diminished. A lack of trust threatens the professional's ability to help the client in accordance with his public pledge to do so. The client takes that pledge at face value, but then discovers – once she is already in the doctor's or dentist's office – that the pledge is a form of false advertising. The doctor is interested in pushing product instead of healing her. The trust will be further damaged if the products the professional is selling turn out to be dangerous. One peer-review concluded that "almost half of the supplements studied were potentially toxic and that an incredibly high number of them, when combined with prescription drugs, showed they had the potential for adverse drug reactions" (Gianelli, 1999). Professionals who participate in

MLMs have an affirmative duty to investigate thoroughly the product claims made by these MLMs. However, since people are attracted to the MLM as an easy way to make money and to realize their dreams (see below), it is unlikely recruits will do such an investigation.

Judges face a slightly different ethical problem when they get involved with MLMs. As we have seen, MLMs urge new recruits to recruit others. A MLM distributor makes money by building "legs" or lines of downlines. If a judge is successful, he or she might have legs with hundreds of members. As the network expands, the odds begin to increase that a judge will be asked to try a case in which either a lawyer, plaintiff or defendant is a downline or upline of the judge. In this case, the judge would have an obvious conflict of interest. If the case goes against her downline, the downline might be forced to drop out of the network, resulting in lost revenue for the judge. We don't let judges own securities in companies whose cases they may be asked to adjudicate. The same ethical reasoning surely applies to judges and provides a strong reason for why this class of professionals should not be involved in MLM schemes. The MLMs, however, put no restrictions on recruiting judges or doctors. Anyone is fair game.

Appealing to greed

MLMs typically recruit people by promising them "immediate and unlimited rewards" and "financial freedom" (Equinox International, posted as of 1999) and "geometric growth" (Barrett, posted as of 1999). Prospects are encouraged to dream and to envision themselves earning millions of dollars, living in large houses, driving expensive cars. Indeed, MLMs circulate tales of people who have been wildly successful using their techniques. Success is always measured in purely material terms. These "success stories" may not be good parents or citizens, but they do drive luxury cars and wear costly clothing. MLMs do not invite people to reflect upon their desires or upon what makes for a genuinely good and satisfying life. Instead, the message is one of pure greed – dream of obtaining whatever you would like and then go for it using our system.

As both Plato and Aristotle realized, the pursuit of wealth is not self-limiting. On the contrary, if one's desires are unlimited, no amount of money is ever enough. As Coco Chanel put it, "you can never be too rich or too thin." The good life, by contrast, is a limited and self-limiting life. The practically wise person consciously refuses not to indulge in certain dreams. It is not accidental that Plato portrays the tyrant as a person whose dreams have taken over his life. Every fantasy is potentially reality for a tyrannical soul. By encouraging greed, MLMs put people on a dangerous course – they can be tempted to do whatever it takes in order to realize their dreams.

And, in fact, the internet is littered with letters from disillusioned souls who report that the MLM they joined did not abide by its own rules (no surprise, given that the message is greed, not self-limitation) and that they were told to deceive others. Participants are urged to "fake it 'til they make it" by pretending they are rich. They drive BMW's and live beyond their means, spending up to or beyond their credit card limits, in order to convince their downlines and potential recruits of the truth of the company's promise of unlimited rewards. While MLMs have been prosecuted successfully for enticing recruits using inflated income and profit numbers, these prosecutions do not address the core problem. These dream businesses are greed businesses. And greedy people are never especially thoughtful about the meaning or consequences of their actions.

Conclusion

MLMs pose many ethical challenges. Succeeding in a MLM business is not easy. The attrition rate is high. MLMs consequently depend upon a sales force that continually recruits new salespeople into the MLM. It is easy for MLMs to become illegal and unethical recruitment-centered pyramid schemes. The current measures for protecting distributors are not adequate for the reasons developed above. Some of the ethical problems may be intrinsic to the MLM philosophy and mode of operating. It is hard to see how MLMs could exist if recruits did not

market to friends, relatives, and clients. Yet such marketing is fraught with ethical peril. It would be nice to think that thoughtful participants would avoid such perils, but the rhetoric of the MLM does not leave one optimistic. If people have joined out of a belief that boundless wealth will be theirs if they only work hard enough, they will not be inclined to reflect about the means to this end.

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