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Multilevel Marketing and Antifraud Statutes: Legal Enterprises or Pyramid Schemes?

***Webster v. Omnitrition International, Inc.*, 79 Fed.3rd 776 (9th Circuit 1996)**

Multilevel marketing programs or vertical marketing programs are surfacing with greater frequency in the marketing of goods and services. Such multilevel marketing programs are often promoted through appeals to the entrepreneurial spirit and wealth creation. In *Webster v. Omnitrition International, Inc.*, the Ninth Circuit Court of Appeals examined the differences between legal multilevel marketing programs and fraudulent pyramid schemes. The central issue was whether Omnitrition could establish as a matter of law that its sales and marketing program was not a pyramid scheme. Pyramid schemes are regarded as inherently fraudulent (*S.E.C. v. International Loan Network, Inc.* 297 U.S. App. D.C. 22 [D.C. Cir. 1992]).

Omnitrition International, Inc., is a multilevel marketing corporation that sells nutritional supplements, vitamins, and skin care products. Omnitrition's retail sales force includes different levels of "independent marketing associates" (IMA). In the first level of the sales force, IMAs are referred to as "distributors." To reach the level of "supervisor," they must order a monthly minimum of products. "Supervisors" receive bonuses based on sales to their recruits, who themselves must also meet minimum order requirements. To continue receiving commissions, however, supervisors and their recruits are required to continue purchasing a minimum amount of products each month. This is contrary to a normal scheme in which products are marketed directly to the public at large.

In its defense, Omnitrition identified three policies designed to encourage direct retail sales. First, IMAs had to certify that they sold at least 70 percent of their inventory before being allowed to order additional quantities. However, sales to subsequently recruited IMAs could be used to satisfy this requirement. Second, in order to qualify for commissions based on orders made by subsequently recruited IMAs, supervisors had to certify that they made sales to at least 10 retail customers during the past month. Third, upon the resignation of an IMA from the program, Omnitrition promised to buy back unsold inventory for 90 percent of the invoice price. The district court granted Omnitrition's motion for summary judgment. It held that the plaintiff failed to reach a threshold of whether Omnitrition's program was a pyramid scheme. More specifically, the district court determined that since the policies of Omnitrition were designed to encourage retail sales, the program was outside the definition of a fraudulent pyramid scheme. The district court also held that Omnitrition's distributorships were not securities as defined by federal securities laws because their return did not depend primarily on the efforts of others.

In reviewing the district court's decision, the Ninth Circuit cited *In re Koscot Interplanetary, Inc.*, in which the Federal Trade Commission established a test for determining the elements of a pyramid scheme. *In re Koscot* defined pyramid schemes as typically involving the payment by participants of money to the company in return for which they receive the right to sell a product, along with the right to receive compensation for recruiting other sales agents. The Ninth Circuit remarked that the second element is the sine qua non of the pyramid scheme. The presence of this second element, "recruitment with rewards unrelated to product sales, is nothing more than an elaborate device in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed." It expressly adopted the *Koscot* holding that the operation of a pyramid scheme constituted fraud for purposes of several federal antifraud statutes.

Omnitrition maintained that there was no pyramid scheme since its "distributors" did not have to pay to participate. The Ninth Circuit responded by noting that the distributor level was only one small part of Omnitrition's program. The "supervisors" did receive bonuses for recruiting and had minimum monthly order requirements. The court held that Omnitrition's only defense was if they could show that recruitment bonuses were tied to actual retail sales. The facts indicated otherwise. The basic structure of Omnitrition suggested that the focus of the company was more on promoting the program than in selling its products. Monetary rewards were tied to recruitment and not to actual sales.

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Omnitrition further argued the previously created "Amway defense." The FTC determined that Amway was not a pyramid scheme. Its policies encouraged retail sales and prohibited "inventory loading." This occurs when distributors make the minimum required purchases to receive recruitment-based bonuses without reselling the products to consumers. Amway's policies required participants to buy back any unsold inventory from their recruits. Moreover, each participant was required to sell at wholesale or retail at least 70 percent of the products in a given month to at least 10 different consumers in order to receive a bonus (*In re Amway Corporation* 93 F.T.C. 618 [1979]).

The Ninth Circuit rejected the "Amway defense" because in *Amway* it was found as a matter of fact that Amway's policies were enforced and that their rules did indeed encourage retail sales. Simply having rules similar to Amway's is only the first step in the pyramid scheme inquiry. The real issue is whether the program's safeguards are enforced and actually serve to encourage retail sales and deter inventory loading. The Ninth Circuit indicated that the record did not reveal sufficient evidence to establish as a matter of law that Omnitrition's rules were actually enforced.

With respect to federal securities laws, the Ninth Circuit had previously held in *S.E.C. v. Glen W. Turner Ent., Inc.* 474 F.2d 476 (9th Cir 1973) that investments in a pyramid scheme were "investment contracts" and thus securities within the meaning of federal securities laws. Accordingly, in the event Omnitrition could be determined to be a pyramid scheme, investments in the program's supervisory positions would be covered under the securities laws. Moreover, if Omnitrition's program did involve the sale of securities, Omnitrition could be liable for failing to file a registration statement. The court also held that the operation of a pyramid scheme could constitute fraud for purposes of Section 12(2) of the Securities Act of 1933 and Section 10b-5 of the Security Exchange Act of 1934. Section 10b-5 prohibits engaging in an "act, practice or course of business which operates as a fraud or deceit upon any person." A jury could reasonably infer that the promotion of an alleged pyramid scheme demonstrates fraudulent intent for purposes of a Section 10b-5 violation. Finally, it held that an organizer of a pyramid scheme was liable under the federal RICO statute. The use of the mails and wires in furthering of the alleged pyramid scheme constituted securities fraud, mail fraud, and wire fraud.

The Ninth Circuit concluded that "on its face, Omnitrition's program appears to be a pyramid scheme." Moreover, Omnitrition could not rely on the fact that it makes some retail sales. "The promise of lucrative rewards for recruiting others tends to induce participants to focus on the recruitment side of the business at the expense of their retail marketing efforts, making it unlikely that meaningful opportunities for retail sales will occur." In the final analysis, the Ninth Circuit made it clear that multilevel marketing programs would have difficulty establishing that they were not pyramid schemes *as a matter of law*. In such organizations, genuine factual disputes are likely to exist as to how such companies actually operate and whether their focus is more on recruiting than retailing. Accordingly, the issue of whether multilevel marketing programs are in fact pyramid schemes is likely to be determined at trial on a case-by-case basis pursuant to the *Koscot* test and the *Amway* defense.

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Franchise Supply Agreements: Quality Control or Illegal Tying?

***Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 922 F. Supp. 1055 (E.D. Pa. 1996)**

Successful franchise systems offer quality goods and services that appeal to a substantial number of customers. In order to ensure consistent quality throughout its franchise system, Domino's Pizza, Inc. requires that its franchisees buy the necessary ingredients and supplies from a Domino's-approved supplier. Queen City Pizza and 10 other franchisees maintained that Domino's unreasonably withheld its approval of alternative sources of supply. The plaintiff-franchisees alleged that this practice amounted to an illegal tying arrangement in which the purchase of supplies was tied to the retention of a Domino's franchise license. The district court dismissed the claim in favor of the rights of the franchisor.

The court listed five elements required to establish a per se illegal tying arrangement. First, there must be two distinct products involved. Second, the purchase of one of the goods must be conditioned upon the purchase of the other product. Third, the seller must enjoy substantial economic power in the product market. Fourth, the tying contract must have anticompetitive effects or injure the competitive process. Fifth, the tying contract must involve a not insubstantial volume of commerce. The third element pertaining to market power is often the major focus of the judicial inquiry. In *Queen City*, the court observed that Domino has little market power in the selling of franchise licenses. Prior to signing a franchise contract, a franchisee has literally hundreds of franchise options. *The Franchise Opportunity Handbook*, published by the U.S. Department of Commerce, provides information on some 1,500 franchise systems. These franchisors must compete with one another for prospective franchisees. No single franchisor has significant market power to exploit a tying arrangement.

Queen City argued that even though Domino's did not possess *precontractual* power in the market for fast food franchise licenses, it acquired *postcontractual* power to coerce its franchisees into a tying arrangement. Domino's refusal to approve competitive sources of supply changed the rules of the game subsequent to the signing of the franchise agreement. The considerable time and money that the franchisees have invested in their Domino's franchises would be lost in the event of termination. Thus, Domino's market power derived from the franchise agreement itself and not from a traditional antitrust definition of market power. The court acknowledged this argument by stating that "the economic power Domino possesses results

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