Distinguishing Pyramid Schemes and Multilevel Marketing

Key criteria for when multilevel marketing becomes a pyramid scheme

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Abstract:
The number of multilevel marketing organizations has been increasing, and the number of people involved is increasing exponentially. As more people become a part of the multilevel marketing business model, the negative impacts of some multilevel marketing organization practices on people's lives is growing due to the high potential for moral hazard amongst multilevel marketing organization leadership. It is my contention that new legislation to protect people involved in this type of organization is critical to dramatically reduce the potential for moral hazard. This paper contends that the practices of some multilevel marketing organizations currently can be comparative to pyramid schemes, which is known to have high moral hazard. But the franchise model, which originally had the potential for similar moral hazard, has been greatly reduced through prudent legislation. The ability of this model to minimize the potential for moral hazard maximizes fairness for all parties involved. Therefore, the franchise model guidelines will be examined to provide for a new model for dramatically reducing the potential moral hazard issues posed currently by multilevel marketing organizations.
Key words: multilevel marketing, pyramid schemes, franchises, moral hazard

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1 Introduction

Since the 1990s (Vander Nat & Keep, 2002), there has been extraordinary growth in multilevel marketing organizations (also known as MLMs). The MLM model is a type of direct sales. Participants work as independent agents. This means they are not technically part of the organization, but operate independently within the business model. As each independent agent makes sales, they receive a commission. After recruiting other people, the recruited people become a part of the participant's downline. The people that recruited the downline (these people are called the upline), receive a combined commission from their sales and the downline's sales. Some MLM organizations also include bonuses. These bonuses are extra payments normally as a result of reaching sales or participation hurdles. MLMs have the potential for the upline to take advantage of the downline in a way similar to that of a pyramid scheme.

Pyramid schemes are an illegal form of multilevel marketing. They use much of the same organizational characteristics, including the upline recruiting the downline, but also include extreme moral hazard issues. Early pyramid schemes used only the the promise of future returns to lure participants. Participants would realize returns by recruiting more into their downline. As more people were added to the model, the likelihood of realizing a larger return increases with each level added. This means there's an incentive for a person in a particular level to recruit as much and as fast as possible without helping their downline. This is especially true for modern pyramid schemes that include a product, rather than just returns. In this model, adding more people to the pyramid increases the likelihood of other people being unable to make money, but the upline continues to recruit others because the negative effects do not impact them. Therefore, there is a moral hazard for the upline, leaving the downline unprotected.

In a franchise, franchisors grant franchisees licenses to operate a business, sell a product, do a service, et cetera, for a fee. This fee may be a flat fee or a percentage of revenues, called royalties. Historically, there was an incentive for franchisors to misrepresent earnings potential to sign on more franchisees and increase fees, sell more inventories, and sell other products to franchisees. These moral hazards were resolved through prudent legislation. The resolutions are all related to protecting current and future franchisees.

MLMs are comparable to franchise models based on the interactions between participants. Both models can have moral hazard as a result of the upline's ability to make money despite the results of the downline. Franchises' moral hazards, though, have been largely resolved. Using their similarities as a basis, this paper uses key areas of franchise history to show where MLMs fall on the moral hazard continuum. Instead of using the entire franchise model, this research focuses on three areas (full disclosure, inventory purchasing and organizational structure) for six MLM organizations in Minnesota.

Full disclosure refers to some type of documentation clearly outlining important factors for a potential participant in deciding to join or not. Key areas include past cases against the organization, past performances of other participants, operation details, and contract obligations. By having full disclosure, the downline knows exactly what to expect and keeps the upline from having excess moral hazard issues. Because there are no current requirements to make any full disclosure document for MLMs, it was expected that this area would be major source of moral hazard. Indeed, the downline would be greatly protected from adding a disclosure requirement.

Inventory purchasing refers to the requirements of the MLM organization to purchase certain materials, including inventory, start-kits, and training material. In franchise history, franchisors were requiring purchases of excess goods over the products needed for business

operations. The moral hazard here would be to increase sales of goods to increase revenue growth. Again, this ignores the growth of the business and the downline. The resolution for franchises were to allow only required purchases of material necessary to running the business or to keep a consistent brand name. Since there have been so many legal actions taken against MLMs in relation to inventory loading, a process where the upline forces purchases of excess inventory by the downline to increase the sales number, many MLMs may be avoiding any hint of issues with inventory purchasing. As such, this area is not a source of the moral hazard in MLMs.

The last area is about organizational structure. The idea is based on the natural limitations on the moral hazard of exponential growth and recruitment for franchises. Since the model only allows the franchisor to add participants, the downline is limited to one level. Pyramid schemes encourage limitless recruitment, multiplying the number of levels with each additional recruit. The attempt here is to determine if the same moral hazard in pyramid schemes exists in MLM organizations. For each additional level allowed in an MLM, there is greater moral hazard potential.

If these three areas of application could be used as guidelines for future MLMs and legislation, then much of the potential for moral hazards could be eliminated. The result would be better protection for downlines. As downlines operate profitably to the benefit of all stakeholders, the overall wealth generated in the area would increase, allowing for greater economic benefits and growth. This is especially true if the exponentially growing number of MLMs would all proscribe to the same guidelines. As MLMs become a larger part of the economy, the impact of these areas on the economy would be even greater. Part of this impact results from the participation rates. In 1998, participation in MLMs increased to 9.7 million

people (Sparks & Schenk, 2001). This is about ten percent of the total work force in the US. But, the focus of this paper is on finding which area creates the most moral hazard as compared to franchises.

Using franchises as a model for understanding potential changes in business practice in the future, and for future legislation, will help protect future downlines from unnecessary moral hazards. Many of these moral hazards stem from a lack of value added. Businesses today exist to add value for almost all stake holders, including consumers, the business person, the community, and the shareholders. In pyramid schemes, the result of the moral hazards inherent to the business model is to ignore the needs of other stakeholders. After legislation changes, franchisees and franchisors added value to the overall franchise and each individual franchisee. So when looking at MLMs, it becomes a question of how much and for how long an MLM creates added value to any stakeholder. After reducing the potential for moral hazards, MLMs will be another way for a business to quickly grow and gain market share, much the same way franchises do.

2 Literature Review

The business model for an MLM is not intuitive. Further, pyramid schemes and other unethical and illegal forms confuse many people with the similarities. It is important, then, to understand the background and definition of these models, but understanding the definitions does not guarantee clear differentiation between MLMs and pyramid schemes. In order to help demonstrate this point, this section is divided into four subsections: background and definitions, technical legality and spirit of the law, key observations and ethical questions about MLMs, and conclusions about the ethical environment.

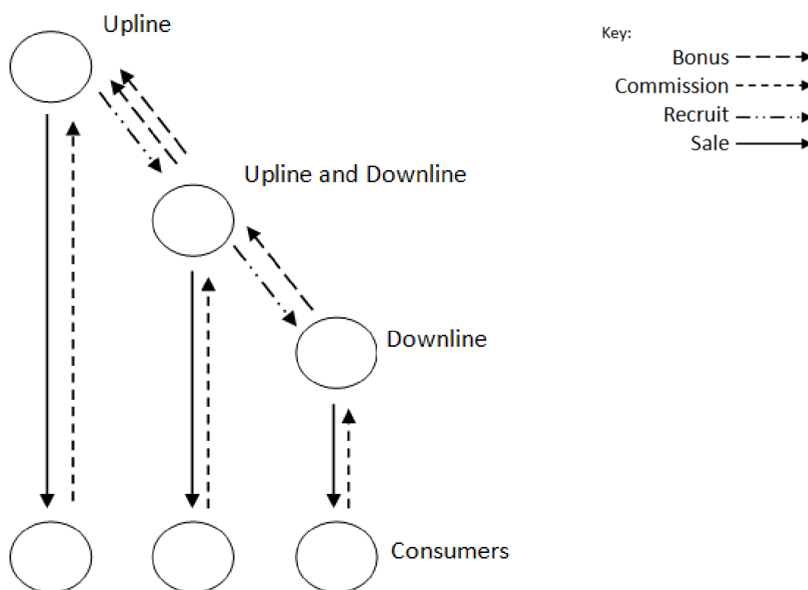
2.1 Background and Definitions

MLMs are forms of direct-selling organizations. Historically, direct selling firms use a sales force of independent agents earning a commission on sales (Coughlan & Grayson, 1998). Koehn defines an MLM as the following:

> Multi-level marketing… refers to the practice of distributing, selling or supplying products or services through various levels of independent agents. 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. (Koehn, 2001, p. 153.)

Many MLM organizations also include payment based on sales by downlines, members a person recruits, and the recruits of the downline (Sparks & Schenk, 2001). (See Figure 1 to visually understand this model.)

Figure 1: A visual model of the operations of an MLM



A pyramid scheme works in much the same way. The key difference between pyramid schemes and MLMs is the promise of large profits from recruitment with an investment in a potential business opportunity for pyramid schemes (Valentine, 1998). Therefore, the definition

of a pyramid scheme is a "property-distribution scheme in which a participant pays for the chance to receive compensation for introducing new persons to the scheme, as well as for when those new persons themselves introduce new participants" (Pyramid scheme, 2009, p. 1357).

In both models, a percentage of the downline's sales continue to move up to the upline until it reaches the first investor. MLMs today often differentiates between participants based on the size of the downline and the amount of participation. For example, many MLMs create sales through parties hosted by a participant who does not create a downline. This host is supplied by a participant whose role includes recruiting downline and other host participants.

2.1.1 History of MLMs

The first multilevel compensation plan is commonly attributed to Carl Rehnborg. He founded the California Vitamin Company (later called Nutrlite Products, Inc.). Rather than allow his salesmen to only receive one-time fees, he created a way for them to have a steady income through recruiting other salesmen.

Poe (1999) categorizes MLM history into four different waves. According to him, these waves are Wave 1 (1945-1979), The Underground Phase; Wave 2 (1980-1989), The Proliferation Phase, Wave 3 (1990-1999), The Mass Market Phase, and Wave 4 (2000 and beyond), The Universal Phase.

2.1.1.1 Wave 1 and 2

Poe (1999) marks the beginning of Wave 1 when Rehnborg introduced his new compensation plan in 1945. The idea spread in legitimate and fraudulent arenas, making it the "Wild West phase." In essence, the Wild West phase was marked by con men taking advantage of other people. The end of this phase came from the decision in the Federal Trade Commission ruling on Amway Corporation. Discussion on this case will

follow later in the "Federal Trade Commission" section 2.1.2.1, but the main result was the requirement of policies to prevent fraudulent actions. Decisions made by the Federal Trade Commission prevented much of the blatant fraud of the time.

During the 1980s, the MLM model slowly grew, spreading only as quickly as hard-working people could continue trying to accomplish their goals. Since the model required a lot of personal commitment, many people dropped out before they saw any rewards (Poe, 1999).

2.1.1.2 Wave 3 and 4

Wave 3 is categorized by the exponential growth of the existence and knowledge of MLMs (Poe, 1999). From 1991 to 1998, MLM participation went from 5.1 million to 9.7 million members and $13 billion sales to $23 billion sales (Sparks & Schenk, 2001). This growth was facilitated by the change in technology, like satellite television broadcasts and dedicated voice mail systems. Recruiters could now recruit and train their downline faster. With more downline, they could make more money with less work. In short, technology lowered the cost of creating a successful MLM and downline (Poe, 1999).

In the last wave, Poe suggests that the MLM model will become universal and dominate the corporate world. Indeed, the estimated sales for 2010 are almost $28 billion (Direct Selling Association, 2012). Though it does not represent the same rate of growth as the 1990s, this does mean MLMs are still becoming a larger part of the economy. Poe makes it seem like this growth encompasses a huge part of the economy. In reality, the sales is about the same amount of sales as the retail jewelry, luggage and leather goods store sales, according to the US Census Bureau, which is less than 0.1 percent of total

retail sales, including services (Monthly & Annual Retail Trade, 2012). But the participation to create these sales represents at least ten percent of the total workforce in the US.

2.1.2 Legal History

The definition found in Black's Law Dictionary says a pyramid scheme is a "property-distribution scheme in which a participant pays for the chance to receive compensation for introducing new persons to the scheme, as well as for when those new persons themselves introduce new participants" (Pyramid scheme, 2009, p. 1357). This definition's first known use was in 1949, four years after Rehnborg starting using his multilevel compensation plan during the Wild West phase. A pyramid scheme, then, can be viewed as one of the first fraudulent programs taking after the MLM model. As pyramid schemes took advantage of more people, states and the federal government needed to react. The following two sections will look at some key legal precedents related to MLMs at the federal level and for Minnesota.

2.1.2.1 The Federal Trade Commission

Stone and Steiner (1983) look at the role of the Federal Trade Commission (FTC) in the history of MLMs. (A summary of all the most relevant federal cases are listed in Table 1.)

Table 1: A summary of historical legal precedent for MLMs and pyramid schemes (Anonymous 1996; Stone & Steiner Jr, 1983)

Case	Summary of Conclusions
Ger-Ro-Mar	Inherently deceptive approach - misrepresentation of earnings potential since not all participants could possibly reach the quoted earnings potential
Koscot	Definition of a pyramid scheme: 1. Pay consideration for the right to sell product and receive rewards for recruitment 2. Focused on recruitment rather than the market
Amway	Existence of policies to prevent fradulent behavior
Omnitrition	The existence of policy is not enough, but must be enforced to encourage retail sales and prevent inventory loading

In the early existence of pyramid schemes, the FTC used an antilottery approach. Using the three elements of a lottery, the FTC was able to prosecute the pyramid schemes.

Table 2: A comparison of lottery elements with corresponding elements of pyramid schemes (Stone & Steiner Jr, 1983)

Lottery Elements	Corresponding Pyramid Scheme Element
A prize,	A profit
according to chance,	It is beyond the control of an individual to achieve the prize.
for a consideration.*	An investment fee or purchase

*consideration: something of value

A lottery is a price, according to chance, for a consideration. In a pyramid scheme, a participant receives a chance to make a profit for an investment fee or purchase. Since it is beyond the control of an individual to influence or control the outcome, it is considered to be left to chance. Using this comparison, the FTC could prosecute the pyramid scheme as having violated lottery laws. When the FTC started regulating games instead of regulating specific industries, they could no longer justify using the antilottery method on only a few select firms and not for all cases, including those related to gambling. (See Table 2 for a comparison of lottery elements and pyramid schemes.)

One case, the *Ger-Ro-Mar* case, was tried in 1974 using the inherently deceptive approach. The inherently deceptive approach means the fraud is built into the business plan. It was extremely difficult for the FTC to find any element of chance in the plan, forcing them to use this approach. From this point on, the FTC stopped using the antilottery approach when dealing with pyramid schemes. The FTC found the company's plan to be inherently fraudulent and deceptive because of the focus on recruitment. The company was also found to be misrepresenting its earning potential: its marketing plan promoted an earnings potential that not all participants could ever make.

Koscot Interplanetary, Inc. (*Koscot*) sold and distributed cosmetics and toiletries. Continuing to use the inherently deceptive approach, the FTC defined a pyramid scheme, based on this case, in 1975 as having two primary elements (Stone & Steiner Jr, 1983): 1) a participant pays money for the right to sell products, and earn rewards for recruiting others into the company; 2) it has an infeasible business plan because of a recruiting focus, ignoring the company's market and misrepresenting earnings.

Koscot incentivized and focused on recruiting to build a large organization. Two theories were used to come to this conclusion: proof of earnings misrepresentation and a mathematical fallacy at the core of the plan. A mathematical fallacy means the business plan was statistically impossible.

Amway Corporation, Inc. (*Amway*) embodies what most people think of as an MLM. It manufactures, sells, and distributes cleaning and personal care products. Unlike its predecessors in court, the FTC found them to be a legitimate MLM because of several policies it has in place. The three key rules are the seventy percent rule, the ten customer rule, and the buy-back rule.

Each of these policies, together called the Amway rule, is *Amway*'s way to ensure its participants focused on retail sales instead of recruiting. The seventy percent rule required participants to sell seventy percent of the inventory bought before receiving any bonuses on products sold. In the same way, the ten customer rule had each member selling to at least ten different customers to be qualified for any bonuses. The buy-back rule allowed a member to back out of the business by forcing the sponsoring distributor (or the upline) to buy back any marketable inventory if asked. This is all to prevent inventory loading. Inventory loading is the process where the upline sells exorbitant

amounts of inventory to the downline in order to receive bonuses for those "sales" when the downline could not possibly sell the entire inventory to customers (Stone & Steiner Jr, 1983).

Since the writings of Stone and Steiner, one more key case has been added to the history of MLMs. *Omnitrition International, Inc.* (*Omnitrition*) sold nutritional supplements, vitamins and skin care products through independent agents. *Omnitrition* had policies very similar to *Amway*'s policies. In this case, *Omnitrition* could not provide any evidence of the enforcement of these rules. The FTC decided, then, that *Amway* was not a legitimate MLM because of its policies, but because the policies prevented inventory loading and over-emphasis on recruitment. Since *Omnitrition* could not prove the same thing, the FTC found it to be a pyramid scheme (Webster v. omnitrition intern., inc., 1996). This case means that an MLM must have and enforce policies encouraging retail sales and preventing inventory loading. Federally, all these cases help regulate MLMs in their inventory recruitment and inventory purchasing practices.

2.1.2.2 Minnesota

In Minnesota, the first introduction of MLMs into the state statutes occurred in 1971 when Subdivision 2 (2)(a) was added in 1971 to statute 325F.69 (Office of the Revisor of Statutes, 2011). The reason for this change was in response to the increasing existence of pyramid schemes during the same period. Wording for the statute was modeled after other states' statutes addressing the same issue. The focus of the statute is to prevent the existence of firms using a product as a front but focusing on recruitment (State v. Solem, 1974). See Appendix B for the full text of the statute.

2.2 Technical Legality and Spirit of the Law

When reading the definitions for pyramid schemes and MLMs, the similarities are clear. In practice, the difference becomes even more blurred. Many MLMs intentionally search for loopholes in the legislation to avoid potential scrutiny (Epstein, 2010). Despite much interpretive case law, MLMs find ways to bend or go around these interpretations.

Koehn (2001) shows how legal multilevel marketing companies can become illegal in practice by discussing the current standards for legitimacy. (The results are summarized in Table 3.) Each point of legitimacy was created to prevent blatant fraud and misrepresentation by MLMs. They are hard fast rules to help prevent unethical behavior, but the intention of these laws can be violated and circumvented, as proven by Koehn.

Table 3: A summary of Koehn's discussion of MLM legitimacy (Koehn, 2001)

Standards for Legitimacy	Conclusion
Only retail sales made by members	Retail sales should not include internal consumption by the sales force. (Internal consumption creates excess commission and bonuses and internal pressure to buy from the upline.)
Buy-back policies to prevent excess product caches	Distributors need to be aware of the policy and buy back at close to the same price as the purchase price
Low upfront-fees for the right to participate	The definition of "upfront-fee" and "low" is dependent on each business
Voluntary purchase of training materials	Even if voluntary, should not be at inflated costs. Participants should be able to return training materials in the same way as unsold inventory

When MLMs monitor their retail sales, one problem is self-consumption. Self-consumption comes from internal pressure within the organization for agents to buy their own products and create sales revenue, especially with the upline selling to the downline. Since the upline receives bonuses and commissions from the downline, even ethical MLMs create high levels of this kind of pressure.

Internal pressures will also attempt to keep participants involved in the MLM. Sometimes this manifests in preventing a participant from selling back unsold inventory. The purpose of a buyback policy is to provide a right to back out of the business for any agent. Even still, some companies may not make their agents aware of the buyback policy, making the policy worthless. Also, there is no incentive for the upline to buy back from their downline, since they make commissions on the sale of inventory. Even if they do buy back, it often times is not at a fair price, making it difficult for the downline to get their investment back. In both cases, it creates a lock into the company with no way out, a situation similar to pyramid schemes.

Getting started at an MLM often includes up-front fees and a sales/training kit. In an ethical MLM, these costs will support a participant to become better at the business. As an MLM makes larger amounts of its revenue from upfront fees, sales kits, or training materials, it makes the company look more recruitment-based and, therefore, more like a pyramid scheme. The problem is defining how much is a significant amount. Each case is dependent upon the expertise and opportunities available. Koehn does not examine possible actions to create a system for examining each case and creating a standard for business practices.

Technically, firms behaving as Koehn discusses, manipulating the interpretation with special circumstances, would be able to pass as legitimate. Instead of only looking at the technical, Koehn concludes that each MLM must be closely scrutinized by the head of the MLM or some other authority to ensure the firm acts ethically. These ideas support using a new framework to analyze MLMs so there can be actions to prevent further unethical behavior, as indicated through moral hazard.

2.3 Key Observations and Ethical Questions about MLMs

Many MLMs have an almost cult-like pressure for people to recruit more people or to remain in the organization (Epstein, 2010). These pressures along with the loose interpretations of law pose a moral hazard for MLMs. Based on these studies, MLMs may be legal, but they do not have a completely ethical perception.

2.3.1 Greed Appeal

The most significant issue with MLMs is their appeal to greed by promising unlimited growth and success through an exponential model. The opportunity is almost too good to pass up. MLMs capitalize on this idea by circulating stories of extremely successful people, encouraging the downline to dream big and achieve those dreams through the MLM model (Koehn, 2001).

To further clarify this issue, consider a chain letter, an illegal form of business similar to a pyramid scheme. A man created a chain letter with ten people listed and sent it to ten other people. The recipients of the email must then send money to the person first on the list, add their name to the bottom of the list, remove the top person, and then send it out to ten more people or bulletins. They will want to do this because once their name is listed at number five, they will get money in return. In the mind-set of the participant, such an easy way to make money should not be passed up, but getting to position five would require ten million people to participate (as shown in Table 4). By the time a participant receives any return, the letter will run out of people to go to. This is assuming everyone listed in the letter participates (Koehn, 2001). The originator knows not everyone will participate and it is not possible for it to grow this far. Instead, he hopes to make money on the first few people who participate. The basic idea is that the business model is statistically impossible to continue to exist in the long term. Similar things can happen in MLMs and always happen in pyramid schemes. When differentiating the two models, it becomes

the difference between being product-based, service-based, or recruitment-based (Vander Nat & Keep, 2002).

Table 4: This shows the number of participants needed to be in position five for the David Rhodes chain letter (Koehn, 2001).

Number of Copies	Participant Position
10	not listed
100	10
1,000	9
10,000	8
100,000	7
1,000,000	6
10,000,000	5

2.3.2 Societal Relationships

MLMs rely heavily on personal relationships to build success. Participants are encouraged to use social connections for sales, referrals, and recruitment. These acts are “socially and psychologically unacceptable to most people in our society” (Bloch, 1996). The reason for this is because the relationship’s status and health is dependent on the success of the MLM and, in particular, the participant. Legara, Monterola, Juanico, Litong-Palima, & Salom (2008) say MLMs must create a constant commission stream by recruiting more people into the organization. The membership growth most often comes from the recruitment of a participant’s social network (2008). The more the participant uses social relationships, the more the relationship and the participant is defined by the MLM organization, and business failure for the participant could lead to serious harm in the personal relationship.

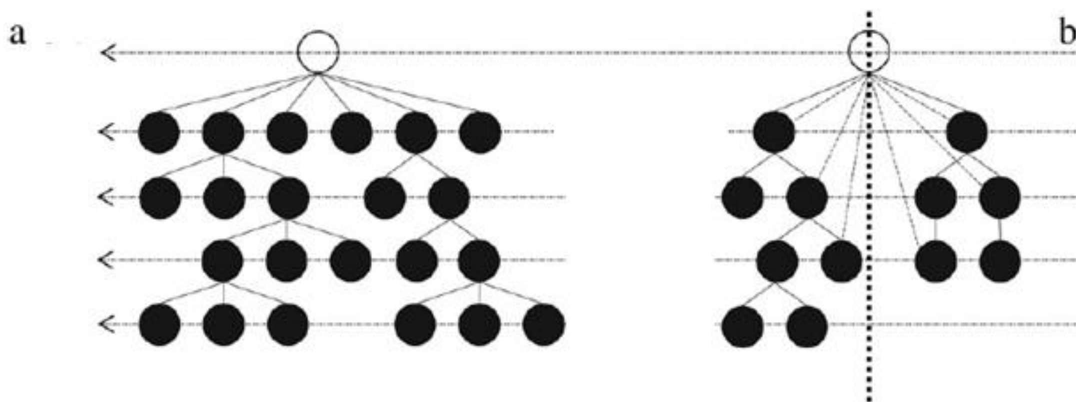
2.3.3 Unethical Structures

It is difficult for a new entrepreneurial manager or a new employee in an MLM to define the ethical and often legal line before crossing into illegal pyramid schemes. Vander Nat and Keep (2002) further accentuates this idea, even pointing to the imprecision of MLMs’ technical

terms and use of financial terms in their model. In their entirety, he continues by saying they are not built to create viable retail organizations.

In the study done by Legara et al. (2008), a statistical analysis was applied to two different types of downline organizations, unilevel and binary structures. These two structures describe the number of direct downlines allowed per member. A unilevel structure can have an unlimited number of direct downlines. The binary structure only allows two direct downlines at each level; other direct recruits must be placed at a different level in the downline. (See Figure 2 for a visual on these two structures.) Legara et al. uses the Pareto 80-20 rule to determine fairness of MLMs: if firms have at least 80 percent of the profit earned by 20 percent of its members, they are unfair. By using statistical analysis, Legara et al. determined how much a level earned, putting the earnings into a normal distribution curve to find where the earnings were concentrated. Using this analysis, the binary structure is deemed unethical.

Figure 2: In (a) unilevel structures, the member can have an unlimited number of direct downline. Binary structures (b) can only have two direct downlines. All other direct recruits must be positioned in a different level of the downline (Legara et al., 2008)



These ideas fit with the higher potential for moral hazard as the number of levels increase. In a binary structure, the upline has to add recruits, other than their two direct downlines, to

different levels. A higher number of levels increases the motivation for the upline to focus on recruiting rather than building the business.

2.4 Conclusions about the Ethical Environment

There's been a clear increase in the number of MLMs, especially within the last two decades. Though the total sales amount does not represent a large part of US total retail sales, it can still make a large impact on the economy through the development (or lack of development) of the businesses and the impacts on participant's lives. The FTC already created some of the framework to close off the potential for moral hazard, but these actions were reactive rather than proactive. Minnesota statutes do not operate much better, merely including a term in a list of terms describing some business practices deemed illegal. It does not allow for differences in operation. This paper creates a framework for thinking about MLM organizations' moral hazards through a comparison to franchising. The comparison will serve as a framework for proactively protecting the downline, so business can grow naturally through business development, rather than recruitment.

The other literature has shown how easy it is for an MLM to obscure their activities to circumvent much of the spirit of the law. Many of these issues come as a result of unique business characteristics for each MLM organization (Koehn, 2001). Though it is impossible to regulate or prevent every possible eventuality, my goal isn't to prevent all moral hazard issues, but to eliminate most of them, similar to how most of the moral hazard issues for franchises were eliminated. Even after action is taken, there will always be unscrupulous people who will somehow find a way around justice. The key is to start finding ways to identify areas with the most need for improvement.

The study done by Legara et al. (2008) proves the existence of unfair MLMs by showing a high concentration of earnings in 20 percent of participants in a binary structure. Further still, they describe MLMs reliance on the commission stream and building the downline through recruitment to sustain the commission stream. Vander Nat and Keep (2002) believes social ties build a type of internal market. These conclusions from multiple studies show the inherent perception of MLMs being unethical. So far, though, none of them suggest possible ways to help protect others from further unethical behavior. As previously pointed on, this paper will be way to look at MLM organizations and find areas to take action steps in.

3 Methodology

The methodology outlines how the research was conducted and what created the final conclusions. The goal of this research is to find areas that can be improved on to protect the downline from the moral hazard of the upline by comparing MLMs to franchises. Since measurement of fairness and ethicality cannot be used, this research approach places pyramid schemes, multilevel marketing, and franchises on a moral hazard continuum. Using franchise history ensures the research focuses on areas that have already worked on a business model similar to MLMs. From the conclusions based on select current literature, MLMs are somewhere between franchises and pyramid schemes, though I had expected MLMs to be closer to pyramid schemes on the continuum.

3.1 Data Collected

Analysis was done on six MLM firms in Minnesota (see Appendix A for a list and summary of information for these firms). These firms were found through an informal website with lists of MLMs by state. Comparing these MLMs to franchises required information on their

business model, operations, and compensation plans. I used only information made available from their website. These firms may provide more information when a potential participant expresses interest in the company. Since I did not interact with any of these firms, the research cannot be conclusive for argument purposes, but rather leads future researchers to more research opportunities. But, by using only the website, it makes sure the research stays more high-level rather than looking at unique circumstances. This all assumes the firm knows how to operate and display information well on their website. It also assumes the firm is transparent in the information available. Again, this may not be true. A potential participant may get more information than an outsider.

3.2 Analysis Framework

Franchise history and law is used to create a framework to compare MLMs and franchises. The following subsection (Franchise History) will give a basic understanding of franchises. Franchise business structure and history strongly correlates with MLMs, with few differences. After analyzing the franchise history and resolutions to the moral hazard issues of franchises, key areas will be the focus for this research analysis on MLMs. These key areas include full disclosure, inventory purchasing, and organization structure. The following gives a brief overview of the history and the broad conclusions used for the research.

3.2.1 Franchise History

Franchises operate in a similar fashion to MLMs. Franchisees, the owners of the right to operate within the franchisor's business model, are analogous to the independent sales agents of MLMs. Unlike the MLM model, the franchisees operate a business, the process of performing the service or giving the product, instead of just making sales. Franchising then, is the process of allowing others to operate a business or sell a certain item for a fee.

Franchises have their basis in early Europe. The first modern version of franchising is accredited to I. M. Singer & Co. with their distribution of sewing machines in the 1850s (Wisconsin Department of Financial Institutions). During the 1880s, cities in the United States began granting monopoly rights to utilities. From 1951 to 1969, there was a growth in the number of commercial franchises. As franchising grew, many franchises were faced with possible antitrust violations with the FTC (Federal Trade Commission) because of their over-exaggerations of "limitless" possibilities and the restrictions they placed over franchisees (Gurnick & Vieux, 1999). Franchisor actions made it nearly impossible for many franchisees to be financially successful. After a series of court cases and law changes, the franchises continued to exist as long as they only controlled the business decisions of the franchisee to the advantage of the overall business. In addition, the FTC required the full disclosure of information to all potential franchisees (Herman, 2012). Most regulation of franchises is done at the state level. With so many requirements, the franchising environment has become very complicated, but there are key components that create the franchise environment of today.

From this history, two conclusions can be drawn. First, the growth and regulation of franchises occurred at about the same time MLMs were in creation. Despite the similarities between the two different models, the reason for the difference in regulation creation may be because of the isolation of knowledge; regulators did not have a history to learn from and use in the MLM situation. Another reason for the regulation of franchises, rather than MLM, may be because of the timing of the boom period. Most franchises opened and grew in the mid-1990s. MLM growth boomed in the 1980s to 1990s. Second, franchise law has many similar characteristics as MLM law. Mainly, the regulation between states is slightly different, making

national operation and application more difficult. Even so, franchises have less moral hazard for participants because of these regulations.

Using this history as a basis, three areas of MLMs were looked at: full disclosure, inventory purchasing, and organization structure. In franchising, the full disclosure is reflected in the Full Disclosure Document requirement; franchisors must present all likely franchisees with the document before beginning business. Franchisors are also not allowed to force franchisees to buy goods unless it is helpful for the franchisee and/or the franchise as a whole. Lastly, the organizational structure of franchises naturally limits the moral hazard resulting from recruitment benefits. When evaluating the MLMs, an artificial limit will mimic the same function in franchises. Each area is examined separately to isolate the likelihood of it being the source of the moral hazard issues. These results will be placed into tables listing the elements of the area and if each firm already had business practices as suggested. An example of a table is show in Table 5. These results will show how different MLMs are from pyramid schemes and if there is a specific source of the moral hazard in MLM organizations.

Table 5: An example analysis table

Firm	Element	Element	Element
Creative Memories			
DaisyBlue			
Enzacta			
Nature Rich			
RevvNRG			
Tastefully Simple			

3.4 Assumptions and Limitations

The conclusions and framework of this research needs to be seen within the context used for conducting the research. Because of the scope and scale of the problems and environment for

MLMs, not all factors could be taken into account. The research assumes complete and transparent information by the studied firms. It also makes broad conclusions about the history of franchises. The advantage of using these assumptions is keeping the research preliminary, leaving room for more comprehensive research refining the action steps needed to protect the downline

At the same time, the analysis of the research was limited by my own understanding of law. Without a degree or background experience in law, many interpretations, assumptions, or proposals may not be feasible or likely. However, the research and possible benefits resulting are for laymen who also have limited understanding of law. It is an attempt to extrapolate business practices from law. Later researchers can delve deeper into the ideas presented here, as explored in the discussion section.

The last limitation is using moral hazard as a comparison platform. By using moral hazard to compare pyramid schemes, multilevel marketing and franchising, I assume all the issues arising from the business model results from moral hazard. In fact, there may be other factors influencing the issues. For example, Bloch (1996) points out the reliance on societal relationships for MLM success. There may be underlying cultural and social changes creating these social dilemmas. But, by using a moral hazard standard, I can easily compare the three firms without translation issues and create a platform to make conclusions on.

The last issue relates to qualitative research. Much of the results are left up to discretion and judgment. With an information gap, some conclusions may end up being based on incomplete information. Additional information will give a more comprehensive view. Also, without a numerical analysis, the same data may lead to different conclusions for different

people. This is an inherent limitation of qualitative research. By working and incorporating other literature and opinions, I hope to minimize the amount of interpretation differences.

4 Analysis and Conclusions

The following looks at key points of the analysis, including the process of understanding law. This information will lead to conclusions, possible action steps, and further points of research.

4.1 Areas of Analysis

The following subsections explain the applications of each resolution area associated with franchise history for MLM organizations. Each area has a series of elements to create criteria for analysis. Each element draws from franchise history and previous literature.

4.2.2 Protection from Financial Distress through Disclosure

The first area is based on the "franchise rule," a requirement by the FTC to write a full disclosure document, also called a uniform franchise offering circular. By the essence of the franchise rule, the FTC wants to make sure prospective franchisees have full, accurate information about a franchise before investing (Varney, 1995). This same idea is used to adjust the *Ger-Ro-Mar* case. Instead of making sure firms did not misrepresent the earnings, they should also create a required full disclosure document, similar to the one required for franchises, explaining actual potential earnings, the statistics of achieving higher earnings, and the full operation of the organization.

The results for the six firms in Minnesota are in Table 6. Much of the information required of the MLMs was hinted at on their websites. For example, Tastefully Simple alluded to possible sources for earnings, but did not go into much detail about what a typical agent would

make. This is tied to the disclosure of statistics. None of the MLMs in this study advertised the statistics of the ability to make successful earnings. Not many MLMs would want a potential participant to have any doubt in their ability to make money. As noted in the *Omnitrition* case, people will purchase more than they normally would because they are caught in the excitement and enthusiasm (Webster v. Omnitrition intern., inc., 1996). The use of exclamation points, exciting words (e.g. fun and parties) suggests these MLMs are using the excitement to encourage a person to make a decision about joining or buying product. This creates greater potential for moral hazard later on in operations.

Table 6: The results from full disclosure. "yes" means the firm currently fulfills the element. "NO" means the firm does not.

Full Disclosure			
Firm	**Disclosure of earnings potential**	**Disclosure of statistics**	**Disclosure of operations**
Creative Memories	yes	**NO**	yes
DaisyBlue	**NO**	**NO**	yes
Enzacta	**NO**	**NO**	**NO**
Nature Rich	yes	**NO**	yes
RevvNRG	yes	**NO**	**NO**
Tastefully Simple	**NO**	**NO**	**NO**

4.2.3 Inventory Purchasing

In a franchise organization, franchisors often require the purchase of inventory from the franchisor. The FTC ruled that this requirement ensured consistency in product and brand representation. In other words, the requirement was a key part in the success of the business model. MLMs can claim the same idea for some parts of the model. For the most part, though, this claim is limited to the purchase of the product to be sold. If the MLM requires the purchase of goods and/or business material that can easily be substituted and is not essential to the business success, then the MLM is making unfair requirements of the participants. This is especially true since the participant acts independently, whereas a franchisee is legally tied to the franchisor. Also, the product-purchase requirement made by franchisors benefit the franchisee as

well; franchisees can either get a return on their purchase or create additional earnings. These ideas are relevant to inventory-loading policies as were outlined in the *Amway* case. This area looks at the need for the purchased good for business success, the ability for a participant to purchase a nearly identical item elsewhere, and if purchasing an item could benefit the participant. Determining if the product is essential was more from the idea of business operations. If the item could be bought in nearly exactly the same from a retail store, it is substitutable. If the item is not necessary to keep the business open or to grow the business further, it is not essential.

Table 7 summarizes the results for the elements for the second area. As shown in the table, many of the firms were already operating similarly to franchises.

Table 7: Summary of results for inventory purchasing. "NO" means disagreement with question. "yes" is agreement.

Inventory Purchasing			
Firm	**Essential?**	**No substitutes?**	**Benefit to participant?**
Creative Memories	**NO**	**NO**	yes
DaisyBlue	yes	yes	yes
Enzacta	yes	yes	yes
Nature Rich	yes	yes	yes
RevvNRG	yes	**NO**	**NO**
Tastefully Simple	yes	yes	yes

The reason most of these firms already have these inventory practices most likely comes from the thoroughness of the *Amway* case and the policies represented there. Those policies were designed to prevent inventory loading. Since this is the most regulated area related MLMs, organizations would want to avoid any indication of breaking this regulation. Participants would not need any additional legislation or regulation to protect them from unethical practices in inventory purchasing.

In relation to the initial investments and training kits, the support for the hypothesis is still unclear. Some firms required the purchase of some form of starting kit. Much of the starting

kit could be substituted and did not create significant benefit to the agent. An MLM, then, should ensure that the start-up kit will definitively help the participant improve or get started in the business.

4.2.4 Organization Structure

Franchises are structured similarly to MLMs in that some percent of benefit moves from the franchisee (which could be considered a downline) to the franchisor (a type of upline). The difference between a franchise and an MLM is that franchisee's cannot recruit people to become franchisees under them. Instead of the trickling-up revenue, the franchisor makes money by having a high number of first level franchisees. Legara et al. (2008) already shows the unfair binary structure some MLMs have, but an MLM cannot be structured like a franchise because of the direct sales methodology inherent to the MLM business model. Therefore application of the franchise model will be less direct.

The idea used here is to limit the amount of downline an upline has access to. In effect, it would limit the amount of emphasis on recruiting a firm could have. The *Koscot* case pointed out the fraud of focusing on recruitment only. Pure recruitment focus is clearly fraudulent, but many firms still encourage recruitment indirectly by suggesting an increase in potential earnings just by recruiting more people into their downline. RevvNRG and Creative Memories are two firms in this study doing this action. The conclusion is that recruitment can still be incentivized even with a focus on retail sales. Instead of trying to directly handle this problem, one way would be to limit how far downline a participant could receive benefits from. Doing this would create an almost natural limit to how much recruiting can be done, similar to what exists for franchises. The suggested change would be to limit the downline levels to up to six levels for unilevel structures and three for binary structures. MLMs were examined for indications of indirect

encouragement to recruit; a limit in the number of levels of downline a particular participant can make to receive benefits; and cited earnings potential further than the three levels, for binary structures, and six levels in unilevel structures.

As shown in Table 8, most firms did not have these practices. Many of the firms simply did not display adequate amount of information on their websites. This could tie back to the full disclosure rule.

Table 8: The table shows a summary of the results for organization structure. "NO" means disagreement with the statement. "yes" is agreement with the statement. "n/a" means the company did not support this structure.

Organization Structure				
Firm	**No indrect encouragement**	**Limit**	**Binary limit - 3**	**Unilevel limit - 6**
Creative Memories	**NO**	yes	n/a	yes
DaisyBlue	yes	**NO**	**NO**	**NO**
Enzacta	**NO**	**NO**	**NO**	n/a
Nature Rich	**NO**	yes	n/a	**NO**
RevvNRG	**NO**	**NO**	**NO**	n/a
Tastefully Simple	**NO**	**NO**	**NO**	**NO**

These results suggest a significant possible area for change for MLMs. The structure of MLMs is a big part of their controversy. When the FTC used the inherently fraudulent approach for evaluating *Ger-Ro-Mer*, one of the reasons it was ruled fraudulent was because of its infeasible growth requirements. By eliminating the chance for exponential growth, which creates moral hazard, the downline could be protected from losing money and business.

5 General Conclusions

After looking at full disclosure, inventory purchasing, and organization structure, only two of the three areas could significantly impact the way an MLM operates: full disclosure and organization structure. This means much of the moral hazard for MLM organizations stem from the lack of information and the organizational structure. The lack of information was the biggest part of the franchise changes. We would clearly expect this to be a big issue. Franchises and MLMs share similar histories,

particularly with regard to earnings misrepresentation. Franchises, though, decreased earnings misrepresentation as a result of legislation changes, resolutions put in place by the government. MLM organizations could benefit from the same type of resolutions.

Koehn (2001) suggested inventory purchasing and start-up kits could hide extra costs for MLMs. As a result of the research, there is not any indication that inventory purchasing is a source for the moral hazard. This is most likely as a result of inventory purchasing and inventory loading precedents set by *Amway*. Since there have been so many cases brought against MLMs related to inventory purchasing, I suspect many MLMs want to avoid the implication of issues with their inventory and start-up/training kits.

Therefore, this leaves the last potential source in this research to be the organization structure. Overall, this is a serious source of moral hazard. As discussed earlier, increasing the number of levels of downline increases the potential for moral hazard. Most of the six firms did not limit the number of levels a participant can have in their downline. Part of this stems from each organization's indirect encouragement to recruit. Indirect encouragement mostly came in the form of pointing out the ability for participants to increase their income by having more people in the downline to make additional sales. Thus, the moral hazard stems from the organization's structure, an inherent part of the MLM business model. At this point, MLMs still closely resemble pyramid schemes. Much of their growth potential can only be realized by growing the number of participants. The question, then, is if adding more levels to the organization really does add value. Adding value is the underlying purpose for all business. If, in fact, the MLM model, with the unlimited levels, does not add value, then having the model in existence at all is questionable.

This research has looked at MLMs, their history, and pyramid schemes, an illegal form of MLMs, to regulated model of franchises to find sources of moral hazard. One source stems from lack of information to the downline. Requiring full disclosure would keep the downline fully informed as they make decisions and protect themselves from the upline moral hazard. The other is the same moral hazard source found in pyramid schemes. The organizational structure of MLMs indirectly encourages more

levels of downline. Each added level increases the moral hazard for the upline. Addressing these issues through legislation would protect the downline and address the moral hazard currently present.

6 Discussion

The results indicated that the inherent structure of MLMs most likely is the source for moral hazard. Further still, the basis for these ideas comes from a legal and historical precedent that has been proven successful for franchises. Since we have seen many of the resolutions that eliminated the moral hazard for franchises do not apply to the MLM organizations, then most of the business model and practices are free from much of the moral hazard and lie closely to franchises on the moral hazard continuum. The organizational structure is the only area in this study that is nearly exactly the same in moral hazard as pyramid schemes, explaining much of the confusion between MLMs and pyramid schemes.

The next step would be to see if this lesson could be applied to other business models as well. Take an insurance company, for example. Most insurance agents work independently from the insurance firm at some point in their career. They make money in a commission-like form, taking a percent of the premium paid for the insurance. The rest continues to the insurance firm. This idea is not so different from what MLMs use except the number of levels of downline available to an insurance agent is limited by the amount of premium they can charge, the market's knowledge of other firms, and customers' ability to switch. So then, the insurance companies are naturally limited to the number of levels it can have by the value an agent can add for the insurance holder. Applying it to the MLM model, people need to start wondering where an MLM level adds value. MLM participants do not improve the product by adding more downline. There are no efficiencies for the market to have a multiple levels in a selling process.

Outside of increasing earnings potential for the upline, there does not seem to be any other added value.

Further research also needs to look deeper into the environment of MLMs, more specifically at the reason people join. According to Sparks and Schenk (2001), members join primarily for additional income or a chance to be successful. Others join because of their belief in the product or system. For example selling educational toys helps advance the cause for the early education of children. Believing in the system may simply mean the participant thinks working at home will build stronger family ties while others think of it as a way to take control of their life and future (Sparks & Schenk, 2001). At the same time, MLMs play on the emotions and relationships of people. This is a major ethical dilemma, as already noted. Initial participation, and especially continued participation, may create illogical ties to the MLM, furthering the MLM model. If so, the application of this research should be adjusted, if not eliminated, to account for the human emotion element apparent to the MLM model. Ideas from crowd psychology, social relationships, and behavioral finance would be better applied to the MLM environment.

As shown through this discussion, the potential for moral hazard similar to MLM is present to many different business models. Further research into the ability to apply this style of analysis could help moral hazards for other business models.

Appendices

Appendix A: Companies in Analysis

From www.npros.com

Name	Website	Product	Operations	Compensation Plan
Creative Memories	Creativememories.com	Scrapbooking, stationary and photo album products	Host holds parties and makes sales. Hosts may also become leaders with hosts in downline (six levels of leaders)	Commission on sales in parties, downline's sales, and additional bonuses (including leader promotion levels) Monthly product incentives
Daisy Blue Naturals	Daisybluenaturals.com	Natural alternatives to personal care products	Hostesses hold product selling parties Consultants have monthly purchasing packages and must make minimum sales per month to be active	Commissions in free-product form for hostesses. Monthly award programs included Consultants receive some commission from downline.
Enzacta	Enzacta.us	Products for health and well-being. Main product: PXP forte health drink	Independent business owner (IBO) sponsors another person to be an IBO IBOs make sales to consumers	5-10% cash rewards from purchases 20% residual commission from personal enrollments Bonuses from up to seven levels below
NatureRich	Naturerich-inc.com	Soaps, personal care and nutrition products	Purchase starter package Must generate minimum business volume	Commissions 1. Retail commission 2. Direct sales commissions – sponsoring and selling starter packages 3. Sales from starter packages in

				organization up to seven levels 4. Volume of products sold 5. Level bonuses (from achieving a certain seniority level) 6. Car bonuses 7. Commission from personal organization
RevvNRG	Revvnrg.com	RevvNRG – exotic juice and tea drink	Purchase starter package Sell product independently	Bonuses for signing someone up Percent of downline sales based on personal level Quarterly leadership cruises
Tastefully Simple	Tastefullysimple.com	Gourmet foods and recipes	Can host product selling parties Consultants sell products in parties and as retail; can increase earnings through sponsoring	Party hosts can receive free product Consultants earn 30% commission Third tier (Team Leader) receives 5% of team's sales

Appendix B: Minnesota Statutes 2011

325F.69 UNLAWFUL PRACTICES.

Subdivision 1. **Fraud, misrepresentation, deceptive practices.** The act, use, or employment by any person of any fraud, false pretense, false promise, misrepresentation, misleading statement or deceptive practice, with the intent that others rely thereon in connection with the sale of any merchandise, whether or not any person has in fact been misled, deceived, or damaged thereby, is enjoinable as provided in section 325F.70.

Subd. 2. **Referral and chain referral selling prohibited.** (1) With respect to any sale or lease the seller or lessor may not give or offer a rebate or discount or otherwise pay or offer to pay value to the buyer or lessee as an inducement for a sale or lease in consideration of the buyer's or lessee's giving to the seller or lessor the names of prospective purchasers or lessees, or otherwise aiding the seller or lessor in making a sale or lease to another person, if the earning of the rebate, discount or other value is contingent upon the occurrence of an event subsequent to the time the buyer or lessee agrees to buy or lease.

(2) (a) With respect to any sale or lease, it shall be illegal for any seller or lessor to operate or attempt to operate any plans or operations for the disposal or distribution of property or franchise or both whereby a participant gives or agrees to give a valuable consideration for the chance to receive something of value for inducing one or more additional persons to give a valuable consideration in order to participate in the plan or operation, or for the chance to receive something of value when a person induced by the participant induces a new participant to give such valuable consideration including such plans known as chain referrals, pyramid sales, or multilevel sales distributorships.

(b) The phrase "something of value" as used in paragraph (a) above, does not mean or include payment based upon sales made to persons who are not purchasing in order to participate in the prohibited plan or operation.

(3) If a buyer or lessee is induced by a violation of this subdivision to enter into a sale or lease, the agreement is unenforceable and the buyer or lessee has the option to rescind the agreement with the seller or lessor and, upon tendering the property received, or what remains of it, obtain full or in the case of remains, a proportional restitution of all sums paid, or retain the goods delivered and the benefit of any services performed without any further obligation to pay for them.

(4) With respect to a sale or lease in violation of this section an assignee of the rights of the seller or lessor is subject to all claims and defenses of the buyer or lessee against the seller or lessor arising out of the sale or lease notwithstanding an agreement to the contrary, but the assignee's liability under this section may not exceed the amount owing to the assignee at the time the claim or defense is asserted against the assignee. Rights of the buyer or lessee under this section can only be asserted as a matter of defense to or setoff against a claim by the assignee.

(5) In a sale or lease in violation of this section, the seller or lessor may not take a negotiable instrument other than a check as evidence of the obligation of the buyer or lessee. A holder is not in good faith if the holder takes a negotiable instrument with notice that it is issued in violation of this section.

(6) Any person who violates any provision of this subdivision shall be guilty of a gross misdemeanor.

Subd. 3. **Advertising media excluded.** Sections 325F.68 to 325F.70 shall apply to actions of the owner, publisher, agent or employee of newspapers, magazines, other printed matter or radio or

television stations or other advertising media used for the publication or dissemination of an advertisement, only if the owner, publisher, agent, or employee has either knowledge of the false, misleading or deceptive character of the advertisement or a financial interest in the sale or distribution of the advertised merchandise.

Subd. 4. **Solicitation of money for merchandise not ordered or services not performed.** The act, use, or employment by any person of any solicitation for payment of money by another by any statement or invoice, or any writing that could reasonably be interpreted as a statement or invoice, for merchandise not yet ordered or for services not yet performed and not yet ordered, whether or not any person has in fact been misled, deceived, or damaged thereby, is enjoinable as provided in section 325F.70.

Subd. 5. **Prohibited going out of business sales.** It is illegal for any person to represent falsely that a sale is a "going out of business sale." Any representation that a sale is a "going out of business sale" is presumed to be false and illegal under this subdivision, if at that location or within a relevant market area:

(1) the sale has been represented to be a "going out of business sale" for a period of more than 120 days;

(2) the business has increased its inventory for the sale by ordering or purchasing an unusual amount of merchandise during the sale or during the 90 days before the sale began;

(3) the business, or any of its officers or directors, has advertised any other sale as a "going out of business sale" during the 120 days before this sale began; or

(4) the sale has continued after a date on which the business has represented, expressly or by reasonable implication, that the business would terminate.

Any presumption arising under clauses (1) to (4) may be rebutted if the business shows, by clear and convincing evidence, that the sale was in fact conducted in anticipation of the imminent termination of the business. This subdivision does not apply to a sale in any statutory or home rule charter city that by ordinance requires the licensing of persons conducting a "going out of business sale," nor to public officers acting in the course of their official duties.

Subd. 6. **Deceptive use of financial institution name.** No person shall include the name, trade name, logo, or tagline of a financial institution as defined in section 49.01, subdivision 2, in a written solicitation for financial services directed to a customer who has obtained a loan from the financial institution without written permission from the financial institution, unless the solicitation clearly and conspicuously states that the person is not sponsored by or affiliated with the financial institution, which shall be identified by name. This statement shall be made in close proximity to, and in the same or larger font size as, the first and most prominent use or uses of the name, trade name, logo, or tagline in the solicitation, including on an envelope or through an envelope window containing the solicitation. For purposes of this section, the term "financial institution" includes a financial institution's affiliates and subsidiaries. This subdivision shall not prohibit the use of a financial institution name, trade name, logo, or tagline of a financial institution if the use of that name is part of a fair and accurate comparison of like products or services.

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