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Nicole McNeil Donecker of Marcum.

COMMENTARY

MLMs are similar in structure to pyramid schemes, but with the essential difference that an MLM is considered a legitimate business enterprise and a pyramid is a scheme to defraud. Understanding this difference is paramount for investors.

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I am sure you have heard of Avon and Tupperware, and you may even have their products in your home. Both of these companies are referred to as multilevel marketing companies, or MLMs. Multilevel marketing is a strategy used by some direct sales companies encouraging existing participants to promote and sell their products and services to other individuals and bring new recruits into the business. MLMs are similar in structure to pyramid schemes, but with the essential difference that an MLM is considered a legitimate business enterprise and a pyramid is a scheme to defraud. Understanding this difference is paramount for investors.

MLMs provide products and services to consumers through direct sales channels. Under the pyramid structure of an MLM, participants both sell the product or service and recruit new members to the sales team. As each participant in the MLM expands their team, each level below continues to expand—from one person on level one to three people on level two and then nine people on level three.

Pyramid schemes are, appropriately, also shaped like pyramids. However, pyramid schemes are illegal and often collapse. A pyramid scheme generally does not involve selling products or services. Instead, it relies on the constant inflow of money from new investors finding its way to the top of the pyramid, which makes it, essentially, a Ponzi scheme. The Securities and Exchange Commission (SEC) defines a Ponzi scheme as an investment fraud that pays existing investors with funds collected from new investors. Essentially it is a pyramid scheme as an investment fraud in which new participants' fees are typically used to pay existing participants for recruiting new members.

How to Differentiate Between an MLM and a Pyramid Scheme

The FTC describes several red flags found in pyramid schemes that differentiate them from MLMs.

- Promoters (those trying to recruit new participants) make extravagant promises about the money the participant can earn.
- The promoter encourages the new participant to recruit more people and expand their network since this is key to making money.

- Promoters play on emotions and use high-pressure sales tactics to persuade participants to sign on: “You’ll lose the opportunity if you don’t act now!”
- The new participant is encouraged to buy more inventory than they will ever be able to sell. Inventory purchases keep participants active or qualify them for bonuses and rewards.

The SEC provides additional pyramid scheme red flags:

- In some instances, no real products or services are offered for sale.
- There is a promise of high returns quickly and easily.
- Buy-in is required to participate.
- There is a complex commission structure.

When does an MLM cross the line to become a pyramid scheme? Two distinctions between an MLM and a pyramid scheme are the recruitment of new participants and the composition of commissions. According to the FTC, participants in an MLM are selling products to a consumer, with earnings and commissions based on the participants’ sales. Earnings and commissions can also be based on recruiting new participants and the sales those new participants make to consumers.

Think of this in levels. Imagine that participant 1 recruits participants 2, 3 and 4, and then participant 3 recruits participants 5 and 6. Each participant earns commission on their own sales, plus participant 1 receives commission on the sales made by 2, 3, 4, 5 and 6, and participant 3 receives commission from the sales made by 5 and 6.

With pyramid schemes, earnings and commissions do not necessarily come from sales to consumers. If participants 1 through 6 above were in a pyramid scheme, all participants would earn commission from their own sales to consumers. The difference is that participant 1 will earn commission from the initial buy-in and inventory purchases made by recruits 2 through 6 in order to become participants. Likewise, participant 3 will earn commission from the initial buy-in and inventory purchases of participants 5 and 6. This structure leaves participants 5 and 6 with only earnings from sales to consumers and they will need to constantly reinvest those earnings to buy more inventory. For participants 5 and 6 to increase their commissions, they will need to recruit more participants under them to buy into the scheme and purchase inventory to sell to consumers.

How the Pandemic Affected MLMs and Pyramid Schemes

The pandemic and the recession that followed did not slow down MLMs and pyramid schemes. At the beginning of the pandemic, with many people laid off from their jobs and large segments of the workforce sent home to work, MLMs seemed ideal. Pyramid schemes were also on the rise during the pandemic, like so many other frauds. In the Association of Certified Fraud Examiner's report "The Next Normal: Preparing for a Post-Pandemic Fraud Landscape," 51% of responding organizations uncovered more fraud since the beginning of the pandemic and 71% expect an increase over the next 12 months in the levels of fraud impacting organizations.

In March 2020, the Direct Selling Association (DSA) began surveying its members about how the COVID-19 pandemic impacted company revenue in the United States, with the last update on July 23, 2021. According to more than half of the respondents, comprised of direct selling companies, the pandemic had a positive impact on company revenue. A 2020 industry overview infographic prepared by the DSA shows the number of direct sellers in the United States grew by 7.7 million, a 13.2% increase from 2019. In other words, the pandemic created a prime opportunity for pyramid schemes to prey on people who suddenly found themselves out of work.

‘Washington v. LuLaRoe’

LLR LuLaRoe Inc. is a company famous for selling leggings on Facebook and other social media platforms. LuLaRoe used “levels” for its participants that ranged from “sponsors,” the lowest tier, to “mentors,” the fourth and highest tier. On Jan. 23, 2019, Robert W. Ferguson, the attorney general of Washington, filed a complaint for injunctive relief and other relief on behalf of the plaintiff, the state of Washington, against LuLaRoe and other defendants, including company founders Mark A. Stidham and Deanne S. Brady Stidham and her son, Jordan K. Brady. The complaint alleged that LuLaRoe operated an unlawful pyramid scheme. The complaint alleged that prior to July 1, 2017, LuLaRoe’s bonus package was based on recruitment of new participants (consultants) and the inventory purchased by those consultants, not the product sold by the consultants.

Additional evidence for the allegation that LuLaRoe was a pyramid scheme included:

- The claim that participants could “make a full-time income doing part-time work.”
- The practice of “inventory loading” by encouraging participants to purchase and maintain sizeable inventories to stay active and eligible for bonuses.
- A complicated refund and return policy for participants.

As stated in the complaint, prior to July 1, 2017, LuLaRoe’s bonus program was based on recruitment and inventory purchases by consultants. The bonus program was subsequently changed to bonuses based on sales, rather than inventory purchases. This resulted in a large decline in commissions for participants. The large bonus checks that once ranged from tens to hundreds of thousands of dollars ended. The complaint includes statements by Defendant Jordan Brady during an Oct. 27, 2016, webinar, in which he explained the rationale for the change in policy:

- “We need to get away from being a pyramid scheme. OK!”
- “So, the way we get away from a pyramid scheme and incentivize you as leaders is we change it.”

In February, Ferguson announced a resolution with LuLaRoe agreeing to pay $4.75 million. Four million of that total was to be paid in restitution to LuLaRoe consultants who were residents of Washington state. In addition to the monetary payment, LuLaRoe was required to publish income disclosures, calculate bonuses on retail sales by consultants, conduct random and targeted audits to verify sales to actual consumers, and modify its return and refund policy.

Words From the Wise

While the promise of quick money, working from home, and owning your own business might seem very tempting at first, a 2018 AARP study of MLMs showed that nearly 75% of participants either lost money or broke even. In a Time article from July 2020, Carl Daikeler, CEO of Beachbody, offered this view to those considering an MLM: “This is not something you jump into and instantly make a lot of money. I will literally say, ‘Are you sure? And do you have money saved? Because this is starting your own business, and starting your own business is very hard. Most new businesses that start, fail.’”

Nicole McNeil Donecker *is a senior manager in the valuation & litigation support services group of Marcum’s Philadelphia office. A forensic accounting specialist, she provides investigative accounting and litigation support services to attorneys, insurance companies, financial institutions and governmental entities. Contact her at Nicole.donecker@marcumllp.com.*