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Enforcement

CONSUMER PROTECTION

Deconstructing The Pyramids: Salutory Legislation Proposed in H.R. 5230



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A group of bipartisan sponsors recently introduced into Congress H.R. 5230, the Anti-Pyramid Promotional Scheme Act of 2016. Below, I pose and answer some questions relating to the need for, and the likely impact of this proposed legislation.

Key Features.

- *What are the key features of the bill and how will it change the legal landscape against which pyramid schemes are evaluated?*

As drafted, the proposed legislation resolves uncertainty, clarifies misconceptions and provides principled and common sense guidance to enforcement agencies and courts as to what constitutes a pyramid scheme. This guidance will rectify the unintended welfare reduc-

ing impact of errors made previously by enforcers and the courts. In this regard, the proposed legislation will benefit direct selling enterprises, participants and consumers.

The language of the bill appears to be drafted carefully to ensure that it does not inappropriately handicap or foreclose enforcement efforts. It reaffirms that pyramid schemes fall under the jurisdiction of the Federal Trade Commission and that they violate Section 5 of the FTC Act, a loosely worded, and thus potentially far-reaching, statute. As such, the bill does not redefine radically the legal landscape. Investigations of pyramid schemes and related enforcement actions will proceed as they always have: on the basis of a detailed factual inquiry. By clarifying the lack of a relationship between pyramid schemes and purchases made legitimately for personal use (see below), the bill echoes rather than contradicts recent developments in case law. The pro-

posed legislation will induce salutary changes that discourage the pursuit of theories that fail the test of logic and that mitigate the chilling effects of false positives induced by such logical errors.

Most importantly, the bill facilitates moving past the spurious question of trying to identify who consumed how much of a firm's products to focus instead on questions directly probative as to whether the transactions at issue are legitimate – e.g., whether the product was really consumed. In this regard, the proposed legislation provides needed impetus to shunt the investigation and interdiction of pyramids off the side track on which they have been derailed and back onto the mainline. The passage of this proposed legislation will also enable us to begin an intellectually honest inquiry into how we should balance the social cost of false positives and false negatives. These questions are not trivial, and they merit a dispassionate and reasoned dialog.

Direct Selling.

■ *What is direct selling?*

Direct selling is an approach to sales that is premised on inter-personal engagement between a salesperson and a consumer, in the course of which the salesperson provides information and service, and extends his personal credibility. Because direct selling involves three sets of individuals—parent firms, participants/distributors, and consumers—a fuller answer to this question is tripartite.

To parent firms, the manufacturers or marketers of a product, direct selling is a choice of how to go to market. In the jargon of marketing and economics, it is a channel strategy. Bypassing a “bricks-and-mortar” strategy in favor of decentralized direct selling can be the best choice for firms that would otherwise have to make significant up-front payments just to get onto retail shelves, whose products would have to dislodge deeply entrenched incumbent brands supported by substantial advertising expenditures, who face substantial challenges in cutting through the noise of a cluttered marketplace to obtain consumers' attention, or whose products would benefit particularly from the personal attention and testimony afforded by direct selling. Consumers obtain personalized information and service from a trusted source to help them discern which products are best suited for them. And finally, participants, or distributors, gain a means to supplement their income on their own terms, develop their own business, build human capital, access or further develop social networks, and obtain valued products at a discount to the retail price.

The phenomenon of distributors buying and consuming the product they sell is referred to as “internal consumption.” Given that they have to make a personal investment in direct selling, it is not surprising that many distributors find the product desirable and purchase it for their own use. In fact, participants are attracted to direct selling largely through their purchase and use of the product.

This discussion does involve a fourth set of individuals. Practitioners of fraud have found that the mechanics of direct selling, and the good will enjoyed by direct selling, present an attractive cover for their fraud.

Pyramid Fraud.

■ *What is pyramid fraud?*

A pyramid scheme follows the paradigm of a chain letter. In the prototypical chain letter scheme, an individual is asked to transmit a dollar to the sender of the letter and profits from the endeavor by persuading others to send him their dollars.

The term pyramid derives from the natural development of the scheme. The originator of a chain letter represents the apex of a pyramid. If he obtained funds from two others, the second level would have two individuals. Progressing to the next stage, if each of these two individuals then obtained funds from yet another two other individuals, the third level would have four individuals. And so on, in a geometric progression that proliferates the number of participants.

The reason these schemes are held summarily illegal is readily apparent. At some point, the scheme is bound to run out of new individuals from whom the last cohort of entrants into the scheme can seek a dollar. Thus, a chain letter or pyramid scheme is ultimately bound to collapse.

The transactions defining a pyramid scheme transfer funds from one individual to another without delivering goods or services of commensurate value. More subtly, the existence of pyramids induce doubts about the legitimacy of transactions, undermining individuals' confidence and willingness to enter into transactions. Popular condemnation of pyramid schemes focuses on the transfer of wealth from one person to another. From the perspective of social welfare analytics, pyramids are deleterious because they create no incremental social value while chilling socially beneficial economic activity. That is to say, pyramid fraud is a deadweight to society.

‘Retail Sales.’

■ *What is the “retail sales”/“ultimate user” criterion, and how has it been misinterpreted?*

A bumpy path that twists in and out of compliance with logic traces the contours of the nexus between pyramid fraud and internal consumption (i.e., purchases made for personal use) when it comes to the investigation and interdiction of pyramid schemes. Three stops along this path, defined by court decisions that found pyramid schemes, are required to understand the issue. In chronological order, these court decisions are: (i) the Koscot decision (In the Matter of Koscot Interplanetary, Inc. et al., FTC Docket 8888, 1975; “Koscot”); (ii) the Omnitrition decision (Webster et. al. v. Omnitrition International, Inc. et. al., 79 F. 3d 776, Ninth Circuit, 1996; “Omnitrition”); and (iii) the BurnLounge decision (No. 12-55926, Ninth Circuit, 2014; “BurnLounge”).

The genesis of the confusion regarding purchases made for personal use traces back to Koscot in 1975. The presiding administrative law judge found, on the basis of a variety of qualitative evidence, that some of the Koscot enterprise's activities constituted a pyramid scheme. After finding this violation, the judge entered an order that sought to restrict the future activity of this known fraudster to safe harbors within which we could be certain that it was not perpetrating pyramid fraud. The reasoning underlying the order centers on the observation that pyramid schemes simply transfer money from one member to another without generating value (or legitimate profits). Thus, restricting the Koscot enterprise from issuing payments to participants unless

they had demonstrably been earned through the legitimate sales of a product to third parties was sufficient to ensure the transactions were not part of a pyramid scheme.

So far, so good. There is little to fault in this logic. Because pyramid frauds don't sell meaningful volumes of legitimate product to third parties, restricting a known pyramid fraudster to *only* selling to willing third parties effectively ends that pyramid. Nor does *Koscot* suffer from any faults in its social welfare calculus. Because compelling evidence showed that the *Koscot* enterprise was clearly a pyramid scheme, there was no risk of acting on a false positive, so that the order did not itself risk inducing deadweight loss.

The path now winds away from the straight and narrow of logic. After *Koscot*, the FTC and its expert witness advanced arguments that were premised on a critical logical failure in their interpretation of *Koscot*. Understanding this requires a small refresher course in logic.

Logically, it is undisputed that [if there is a pyramid scheme] then [sales to third parties are minimal]. As with any true statement, the contrapositive of this statement is also true. Consequently, as *Koscot* noted, it is also true that [if sales to third parties are *not* minimal] then [there is *not* a pyramid scheme]. In other words, a demonstration that an enterprise makes meaningful sales to third parties is sufficient, but *not necessary*, to conclude that it is not a pyramid scheme. While we can be certain that all ships sailing within the safe harbor of "third-party sales" are legitimate, we cannot logically conclude that all ships sailing outside the safe harbor are pirates.

This is where the FTC and its associates erred. Mistaking the logical inverse for the contrapositive, they asserted that *Koscot's* correct statement that if [there is a pyramid scheme] then [sales to third parties are minimal] implies that the inverse is also true. Thus, they argued that *Koscot* means that [if sales to third parties are minimal] then [there is a pyramid scheme].

The following example brings the logical error to the fore. Consider a true statement: all zebras are striped animals. Because this is true, we can also conclude that the contrapositive is true, so that if an animal is not striped, that animal cannot be a zebra. However, it is a logical error to assert the inverse, i.e. if an animal is striped, it must be a zebra. Tigers (and skunks!) are indubitably striped, but they are just as indubitably *not* zebras. Similarly, while making minimal third party sales is *necessary* to a pyramid scheme, making minimal third party sales is *not sufficient* to conclude that we have a pyramid scheme.

Yet, the FTC and its expert championed legal arguments based on the logically faulty assertion that an enterprise that does not sell primarily to third parties must be a pyramid scheme. From a welfare perspective, the problem is that this faulty logic tends to create false positives.

This problem came to a head in 1996 in *Omnitrition*, wherein an opinion issued by the Ninth Circuit endorsed this logical failure by equating erroneously "ultimate users" of the product and "third party users of the product". With the wind of a supportive (albeit erroneous) court ruling at their back, the FTC and its expert propagated the error inherent in *Omnitrition*.

However, in June of 2014, eighteen years after the error of the *Omnitrition* court, in the course of ruling that

the *BurnLounge* enterprise was a pyramid scheme, the Ninth Circuit finally and explicitly cleared the record on the matter of internal consumption when it stated that: "[W]hen participants [buy product] . . . for internal consumption. . . participants [a]re the "ultimate users" of the merchandise and . . . this internal sale alone does not make [the enterprise] a pyramid" (*Burnlounge*, p. 19).

The Impact.

■ What is the impact of this misinterpretation?

Burnlounge made clear that the court appreciated why it was important to reject the FTC's argument, and rectify past logical errors, regarding internal consumption: "[I]f internal sales do not count as sales of products to ultimate users for the purposes of calculating rewards, then many legitimate [direct selling enterprises] will be incorrectly characterized as pyramids" (*Burnlounge*, p. 18).

Legitimate internal consumption is far from being an esoteric or academic concern. Surveys of direct selling firms and participants show that purchasing for personal use is a widespread phenomenon (see p. 18 and p. 21 of the NERA report). Most distributors began as, and continue to be, consumers of the products they sell and the majority of distributors' recruiting efforts focus on their clients, i.e. consumers of the product.

Legitimate internal consumption is incremental to social welfare, generates legitimate profits and leads to the earning of legitimate commissions. Failing to recognize the facts in this regard, coyly admitting, when pressed, the legitimacy of purchases made for personal use while continuing to argue that internal consumption is an indicator of pyramid fraud, and failing to account for the value generated by internal consumption so as to put a thumb on the scale when performing tests of legitimacy, induces false positives that risk misclassifying legitimate enterprises as pyramid schemes.

Such false positives impose costs on legitimate enterprises and discourage parent firms, distributors and consumers from engaging in socially beneficial activity. By chilling transactions that are incremental to social welfare, false positives themselves induce deadweight loss.

Proposed Legislation.

■ How does the proposed legislation address this problem?

Even after *Burnlounge*, some have sought to minimize or even deny the plain meaning of *Burnlounge's* language regarding purchases made for personal use. Thus, there is a need for legislation to clarify and codify the plain understanding that when purchases are made for bona fide personal use, those sales were made to ultimate users.

Such legislation will have a salutary effect on enforcement not only because it will attenuate the rate of false positives, but also because it will allocate efficiently our scarce enforcement resources. Expending resources to determine the identity of consumers so as to discard improperly the value of internal consumption does not further the cause of principled enforcement and decreases social welfare. A more relevant question is whether the product is actually being consumed by purchasers, rather than serving merely as window

dressings to conceal the transfer payments that are the linchpin of a pyramid scheme.

Transactions between willing and informed individuals in which an object that costs the seller a dollar, but whose consumption is valued by purchasers at more than a dollar, are at the very heart of the realization of social welfare. The proposed legislation will resolve uncertainty and end the bias induced by the continued application of erroneous logic. In turn, alleviating these costs will ease the distorted disincentive for economic actors to shy away from the otherwise beneficial activity of legitimate direct selling. By clearly championing logic and articulating common sense as to legitimate internal consumption being “sales to ultimate users,” the proposed legislation will serve to increase social welfare, i.e. benefit parent firms, participants, and consumers.

Pyramid Enforcement Changes?

- *How is pyramid enforcement likely to change?*

The evaluation and litigation of alleged pyramid schemes will not change in ways that adversely impact meritorious enforcement actions. The investigation and prosecution of alleged pyramid schemes will continue to be deeply fact intensive activities. This is as it should be. Investigative and enforcement resources may be directed away from misguided and irrelevant efforts to identify who is consuming the product, and toward the determination of whether the product is actually being consumed and whether inventory loading or other measures are concealing a pyramid scheme. Again, that is as it should be.

Finally, because many of the arguments advanced by the FTC and activists do not revolve around pyramid fraud, but rather center on the concern that a business opportunity was fraudulently misrepresented, perhaps enforcement resources freed from misguided and irrelevant endeavors will be directed toward answering directly these concerns.

Next Steps.

- *What should our next steps be?*

The key question here is not whether we should interdict pyramid fraud when we find it (the answer to that question is obviously in the affirmative), but rather how we determine whether a given enterprise is a pyramid scheme. The moral outrage underlying the temptation to put our thumb on the scale when it comes to testing for pyramid schemes should be tempered by the sober recognition that we do not have access to a secret decoder ring that discriminates infallibly between legitimacy and fraud. Thus, any proposed standard or litmus test will induce false positives, false negatives, or both. We are imperfect people living in an imperfect world and even our most well-intended policies will induce inequity on some individuals and will impose costs on society. A realistic and intellectually honest dialog needs to consider and evaluate the costs and benefits of differing standards and tests. Such a dialog is a prerequisite to reaching a consensus as to what costs and inequities we are willing to tolerate. When it is obtained, that consensus will provide the basis for further legislation.

