

SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: Commerce and Consumer Services Committee

BILL: CS/SB 2648

SPONSOR: Commerce and Consumer Services Committee and Senator Garcia

SUBJECT: Pyramid Promotional Schemes

DATE: April 20, 2005

REVISED: _____

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Siebert	Cooper	CM	Fav/CS
2.	_____	_____	CJ	_____
3.	_____	_____	JU	_____
4.	_____	_____	JA	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____

I. Summary:

This committee substitute prohibits pyramid promotion schemes. This committee substitute increases the penalty for a person who establishes, promotes or operates a pyramid scheme to a third degree penalty. This committee substitute also defines a safe harbor provision defining conditions by which the sale of goods to plan participants will be considered sales to the general public for the purpose of evaluating a pyramid sales scheme.

This committee substitute substantially amends section 849.091 and creates section 849.09105, of the Florida Statutes.

II. Present Situation:

A pyramid sales scheme is a scheme whereby the primary function of the business is the recruitment of new members for a fee, not the sale of goods and services to the public. The small number of persons at the top of a pyramid scheme can receive a tremendous amount of money, while the large numbers of persons at the bottom of the pyramid typically lose money because the available pool of new recruits has been exhausted and there is no profit from the sale of goods.

Section 849.091, F.S., provides in part that a pyramid sales scheme is declared to be a lottery. It is a first degree misdemeanor for any person to participate in any such lottery by becoming a member of or affiliating with, any such group or organization, or to solicit any person for membership or affiliation in any such group or organization.¹ A first degree misdemeanor is punishable by up to one year in county jail and a fine of up to \$1,000.

¹ Section 849.091(2), F.S.

A “pyramid sales scheme” is defined as any sales or marketing plan or operation whereby a person pays a consideration of any kind, or makes an investment of any kind, in excess of \$100 and acquires the opportunity to receive a benefit or thing of value which is not primarily contingent on the volume or quantity of goods, services, or other property sold in bona fide sales to consumers, and which is related to the inducement of additional persons, by himself or herself or others, regardless of number, to participate in the same sales or marketing plan or operation.² The term “consideration” and the term “investment” do not include the purchase of goods or services furnished at cost for use in making sales, but not for resale, or time and effort spent in the pursuit of sales or recruiting activities.³

In a similar vein, s. 849.0915, F.S., prohibits referral selling schemes. It is a first degree misdemeanor for any person to conduct a lottery by referral selling.⁴ Referral selling is defined as a scheme whereby the seller gives or offers a rebate or discount to the buyer as an inducement for a sale in consideration of the buyer’s providing the seller with the names of prospective purchasers, if earning the rebate or discount is contingent upon the occurrence of an event subsequent to the time the buyer agrees to buy.⁵

The Attorney General, a state attorney, and the Division of Consumer Services of the Department of Agriculture and Consumer Services are each authorized to seek an injunction against a person operating a referral selling scheme.⁶

Pyramid sales schemes are also prohibited by federal law. The Federal Trade Commission has taken the lead prosecuting such schemes as a deceptive and unfair trade practice. The Securities and Exchange Commission has prosecuted pyramid schemes under securities laws (fraudulent representation of expected return on investment). Additionally, the Postal Service has prosecuted pyramid schemes that use the mail as mail fraud.

In practice, distinguishing an illegal pyramid sales scheme from a legal multi-level marketing program is sometimes difficult. The hallmark of an illegal pyramid is that its continued existence depends primarily upon recruitment of new members, and the new member fees that are distributed up the pyramid. The problem with any pyramid scheme is that it eventually collapses as it runs out of new recruits.⁷ By contrast, a legitimate multi-level marketing plan, while having the same organizational structure in the form of a pyramid, and while rewarding recruitment of new members by making progressive payments up the pyramid, continues its existence because it relies on the continued sale of goods and services to ultimate consumers.⁸

Florida law looks solely to the test of whether the marketing plan is “primarily contingent” on the recruitment of new members to maintain its existence. The federal law has developed a more

² *Id.*

³ *Id.*

⁴ Section 849.0915(2), F.S.

⁵ Section 849.0915(1), F.S.

⁶ Section 849.0915(3), F.S.

⁷ Federal Trade Commission, *Multi-level Marketing Plan*, available at <http://www.ftc.gov/bcp/online/pubs/invest/mlm.htm> (last visited April 8, 2005).

⁸ *Id.*

sophisticated model. The two leading cases in the area, both in the mid-1970's, were *FTC v. Koscot Interplanetary, Inc.*, and *FTC v. Amway*. *Koscot* listed several factors that the FTC said are indicative of an illegal pyramid disguised as a multi-level marketing plan⁹ where the *Amway* case created a "safe harbor" for multi-level marketing plans by listing factors that tended to show legitimacy.¹⁰ Since the ruling, multi-level marketing plans that have followed the *Amway* model have been considered legitimate multi-level marketing plans, and not illegal pyramid schemes. The *Koscot* list of bad factors include:

- Large membership fees
- Front-end loading, or inventory loading
- Misrepresentation of the reasonable commissions that members could expect
- Commissions not based on the sale of products to ultimate consumers.¹¹

In contrast, the elements of the *Amway* model that the FTC felt showed legitimacy are:

- A representative must make at least 10 sales calls a month in order to be eligible for commissions
- A representative must sell 70 percent of previously ordered inventory before placing a new order
- The company would buy back unsold inventory at 90 percent of cost.¹²

In examining whether a plan is illegal, one issue that frequently arises is whether sales to members for the member's own use constitute sales to the general public. It is not uncommon for members to purchase the goods for their own use. Indeed, these companies are intended to sell consumer goods, it is logical to think that the best salesperson for a good is someone who is using the good. On the other hand, if the only people buying goods from the company is its own salespeople, then it is little different from the classic pyramid scheme that relies on membership or initiation fees.

III. Effect of Proposed Changes:

Section 1 amends s. 849.091, F.S., to delete the prohibition on pyramid sales schemes in s. 849.091(2), F.S. Section 2 of the bill transfers the regulation of pyramid schemes to a new section of statute.

Section 2 creates s. 849.09105, F.S., to prohibit pyramid promotion schemes. The following terms are defined in this section:

- "Appropriate inventory repurchase program" means a program by which a plan or operation repurchases, upon request and upon commercially reasonable terms, when the salesperson's business relationship with the company ends, current and marketable

⁹ *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106 (1975).

¹⁰ *In re Amway*, 93 F.T.C. 618 (1979).

¹¹ See *Supra* note 9.

¹² See *Supra* note 10.

inventory in the possession of the salesperson that was purchased by the salesperson for resale.

- “Commercially reasonable terms” means the repurchase of current and marketable inventory within 12 months from the date of purchase at not less than 90 percent of the original net cost, less appropriate set-offs and legal claims, if any.
- “Compensation” means a payment of any money, thing of value, or financial benefit conferred in return for inducing another person to participate in a pyramid promotional scheme.
- “Consideration” means the payment of cash or the purchase of goods, services, or intangible property. The term does not include the purchase of goods or services furnished at cost to be used in making sales and not for resale or time and effort spent in pursuit of sales or recruiting activities.
- “Current and marketable” excludes inventory that is no longer within its commercially reasonable use or shelf-life period; was clearly described to salespersons prior to purchase as seasonal, discontinued, or special promotion products not subject to the plan or operation’s inventory repurchase program; or has been used or opened.
- “Inventory” includes both goods and services, including company-produced promotional materials, sales aids, and sales kits that the plan or operation requires independent salespersons to purchase. “Promote” means contrive, prepare, establish, plan, operate, advertise, or otherwise induce or attempt to induce another person to participate in a pyramid promotional scheme, including a pyramid promotional scheme run through the Internet, e-mail, or other electronic communications.
- “Pyramid promotional scheme” as any plan or operation by which a person gives consideration for the opportunity to receive compensation that is derived primarily from the introduction of other persons into the plan or operation rather than from the sale and consumption of goods, services, or intangible property by a participant or other persons introduced into the plan or operation.

This section also provides that no person may establish, promote, operate, or participate in any pyramid promotional scheme. A limitation as to the number of persons who may participate in or the presence of additional conditions affecting eligibility for the opportunity to receive compensation under a plan does not change the identity of the plan as a pyramid promotional scheme. It is not a defense under this section that a person, on giving consideration, obtains goods, services, or intangible property in addition to the right to receive compensation.

Safe harbor provisions relating to personal use by members of the marketing plan are also provided for in this section and that a plan or operation is not an illegal pyramid promotional scheme simply because participants purchase goods, services, or intangible property for personal use, consumption, or resale, provided that the plan or operation does not promote or induce inventory loading and the plan or operation implements an appropriate inventory repurchase program.

This section also provides that it is a third degree felony to establish, promote, or operate pyramid promotional scheme. A third degree felony is punishable by up to 5 years imprisonment and a fine of up to \$5,000.

Further, this section provides that it is a first degree misdemeanor to participate in a pyramid promotional scheme. A first degree misdemeanor is punishable by up to 1 year in county jail and a fine of up to \$1,000. Neither offense requires that the offender knowingly be involved with a pyramid promotional scheme.

Section 3 provides an effective date of upon becoming law.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

None.

C. Government Sector Impact:

None.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Summary of Amendments:

None.

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.
