

Ethics IN Economics

No. 1

COUNCIL FOR
ETHICS IN
ECONOMICS

2 0 0 1

The Pyramid Scheme: A “Devastating Con”

by Robert L. FitzPatrick

It may be true that you can't cheat an honest person, but pyramid schemes prove that honest people will enthusiastically cheat others, including family, friends and neighbors.

From ten years of study of pyramid schemes, authoring a book, debating on TV and radio, serving as expert in court cases and fielding email from thousands of victims and adherents, I can attest that most people who participate in pyramid schemes are not crooks and liars. The victims and the perpetrators are, for the most part, ethical, spiritually minded, responsible, and law abiding.

The city of Columbus, Ohio experienced the spells that pyramid schemes cast over otherwise honest people when Purchase Plus Buyer's Group swept into town. For each \$400 membership in a discount buying club, consumers were promised earnings of \$11,000 if they recruited enough others. Ohio Attorney General, Betty D. Montgomery, sued the company for illegal sales practices, and officials in Kansas and Puerto Rico issued cease and desist orders for selling “unregistered securities.” The news media described the sales program as a pyramid scheme destined to collapse. Purchase Plus temporarily closed its doors, leaving at least \$100 million owing to 65,000 participants. Yet, during the legal prosecution and media exposés, many local residents continued to attend recruitment rallies.

Beguiling our vulnerable sides is not unique to pyramid schemes, but the fact that they are spread by thousands of ordinary people defrauding one another makes them unique among flim flams. The claims of promoters that the schemes are legitimate businesses that empower people make them particularly sinister. The protests of

innocence and denial of responsibility by rank and file participants indicate that better public understanding is greatly needed. In 1996, the Better Business bureau warned that pyramid schemes “are all over the country.”

- In October 1997, 30 Sheriff's Deputies in Fort Lauderdale, Florida were exposed for participating in a scheme called 'Friends Helping Friends' that was run from within the County jail.
- In June 1997, the Greensboro, NC *News and Record* reported that a pyramid scheme called 'Hotel' had attracted much of the city's African-American community, backed by some prominent clergy with meetings held in local churches.
- The *Tri-City Herald* in Kennewick, Washington reported in January, 2000 that the leaders of a pyramid scheme called 'Renewal Celebration Gift Club' “mounted a brazen attack on the authorities who are investigating them.” Scheme leaders filed a \$65 million civil lawsuit against 12 police officers and one deputy prosecutor.
- The Gifting Club pyramid schemes ran rampant in Springfield, Illinois last year.
- The *Boston Globe*, in the summer of 2000, recounted the recrimination, shame and anger that was damaging community life in many small towns in Maine where a scheme called 'Changing Lives' had operated until Attorney General Andrew Ketterer prosecuted it.
- A front-page headline in the *Palm Beach Post*, June,

I N S I D E

What is Pyramid Scheme Alert? 2
For Further Information 3

continued on page 2

2000, read, "Online Mall? Or Pyramid Scheme?" and reported that 60,000 people joined Professional Resources Systems, Inc. (PRSI) an internet-based multi-level marketing company. Boca Raton police seized \$4.5 million in cash and luxury cars. More than 7,000 members then signed a form letter claiming the company is legal and innocent

Most of the formerly socialist countries have been plagued by pyramid schemes, the underbelly of free enterprise. In 1997, a large portion of the population of Albania invested in several schemes. Their collapse led to a violent overthrow of the government whose leaders had permitted and benefited from them. In May, 1998, the People's Republic of China banned all multi-level marketing companies due to its inability to control the growth of pyramid schemes. Riots against the ban broke out in several provinces.

The pyramid scheme phenomenon intertwines the growth of the multi-level marketing (MLM) industry in which distributors are paid overrides on purchase of

other distributors they enroll in an ever expanding, "multi-level" fashion.



What is Pyramid Scheme Alert?

Pyramid Scheme Alert (PSA) is a non-profit consumer awareness and advocacy organization founded in 2000 by Robert L. Fitzpatrick. PSA studies questionable multilevel marketing and pyramid schemes and petitions the Federal Trade Commission to investigate abusive practices. PSA also provides advice to state attorneys general and responds to requests for advice from members of the public.

www.PyramidSchemeAlert.org

(SEC) filed suit against International Heritage, Inc., a multi-level marketing company, calling it the largest pyramid scheme in SEC history. 150,000 Americans were involved.

- Equinox International, which was shut down by the FTC this year, fielded more than 100,000 distributors, held membership in the Direct Selling Association, and in 1996 won the #1 position in *INC Magazine's* list of the 500 fastest growing privately held companies.

These prosecutions show that consumers cannot distinguish a legal MLM from a pyramid scheme. With more than six million American participating in MLMs annually and many times that number having joined during the past 20 years, we face a legal and ethical minefield of enormous proportions.

The fraud of the pyramid is based upon its perverse mathematics. The promised return of investment relies upon an ever-enlarging base of enrollees, which is mathematically impossible to sustain. An each-one-enrolls-five-more scheme will result in 96% of the participants *always* on the bottom two levels where no payback occurs.

But this mathematical trickery can be effectively obscured with monthly purchase quotas, complex organizational charts and indecipherable commission schedules. Disguising the program as "direct" sales of real products, promising high "earnings," giving money to charity, and otherwise acting like a real company, make it very difficult for people to see the fraud. High dropout rates conceal the inevitable market saturation. Unlike franchises, the FTC has no official ruling on what even constitutes a legal MLM and does not require MLMs to disclose market or financial data to recruits.

Dr. Jon M. Taylor of Salt Lake City has spent the last five years studying MLM pyramid schemes and has written a book on the subject. He proposes four defining characteristics for identifying the elusive MLM pyramid:

1. A chaining hierarchy of distributors—more than is functionally justified—is recruited without area limits.
2. Distributors (far up the line from consumers) receive as much or more total remuneration per sale from the company as the distributor who sells the product. This leads to extreme emphasis on recruiting over retailing.
3. A few distributors at the top receive very large payouts from the MLM company, while the vast majority of distributors receive little or none. The losses (potentially billions of dollars) of the many are directly transferred to the few.
4. Significant purchase or recruiting quotas are required to maintain a paying position in the system.

But what is the actual harm of a pyramid scheme? What are its ethical abuses and compromising allurements? Collectively, losses are too far reaching to calculate. They involve billions of investment dollars, months and years of futile effort, livelihoods and careers abandoned or sidetracked during the misguided quest for promised wealth, alienation from family and community relationships, and self-esteem buried in guilt, shame and dashed hopes.

In a recent petition to the FTC for a new inquiry into multi-level marketing, retired Assistant Attorney General from Wisconsin, Bruce Craig, wrote, "Many distributors have lost life savings, stable jobs and their marriages." Despite these dire losses, he adds, "most distributors, after failing in what they thought was a valid business enterprise, are not motivated to complain or seek redress. They have... been conditioned to believe that any failure was their fault."

Attorney Douglas Brooks of the Boston-based firm, Gilman and Pastor, LLP, has successfully sued multi-level marketing companies for pyramid fraud and deception. He participated in the landmark case against Omnitrition International. That ruling by the US Ninth Circuit Court of Appeals serves as the foundation for most FTC actions now. Brooks sees at least three ethical dilemmas for participants caught up in MLM type pyramids:

- Participants must promote an opportunity that does not exist. For the most part, Brooks notes, the persons who succeed in pyramids are involved at or near the inception of the program.... The odds of later entrants succeeding grow ever more dismal the longer the program continues.
- The products or services offered by MLM-type schemes are typically overpriced, or of questionable value, or both. The price must include a markup to fund the huge MLM payouts to the top levels. He notes the marketing of such products as herbal remedies, diet supplements, cosmetics, tax advice, motivation seminars or online "malls" where it is nearly impossible to verify sales claims.
- MLM distributors must exploit their personal relationships through selling both the (overpriced) products and the (bogus) opportunity to the persons most likely to rely on their honesty and character.
- The participant is lured into an insidious lie and enticed to spread the lie to those who trust him most. In a 1998 *60 Minutes* exposé, correspondent Mike Wallace termed the MLM type pyramid a "devastating con."

Investigative journalists frequently ask me why the participants cannot see the inherent fraud, the mathematical implausibility and preposterous promises. Regulators too are discouraged by the silence of victims and the celebrity of perpetrators. Ringleaders seldom admit wrongdoings in court settlements. The founder of Equinox International was allowed to keep \$8 million in cash. After regulators shut down International Heritage, Inc., the top-line distributors organized a similar new MLM in a more lenient state. And, as of

this writing, Ohio-based Purchase Plus Buyers Club is still in business, offering nutrition supplements and trips to Mexico.

A student of pyramid schemes cannot escape the conclusion that lawmakers and regulators are not providing adequate protection. But, poor regulation alone does not account for the massive consumer-to-consumer fraud that pyramid schemes facilitate.

My own analysis has shown that greed, the most frequently cited cause, is the least of the motivators. Purchase Plus members are not the more avaricious residents of Columbus, Ohio. Rather, like many others, they probably hold that wealth and happiness are nearly synonymous and that poverty is akin to sin. In an easy-credit society, they are likely to believe that the good life should be theirs. In a booming economy, they have certainly been led to expect that wealth can be achieved quickly and easily, based on "positioning," not labor or knowledge.

These beliefs and values do not make them unethical, only typical. But they also render them prime candidates for pyramid schemes. They become easy prey to promoters who play upon values of freedom and independence, while also manipulating hopes, insecurities and quiet desperation.

Pyramid schemes are increasingly treated as legitimate enterprises. Participation in the fraud is seen by many as free market "risk." Tricking people into enrolling is viewed as "sales." Legal defense funds, political contributions and public relations programs barricade the MLM industry against regulation. And the damages suffered by millions are mostly endured silently and shamefully, the victims not fully grasping how they were duped or aware that they conned their own friends and family. ■

Robert L. FitzPatrick is the founder of Pyramid Scheme Alert. He is co-author of a major study of multi-level marketing and pyramid schemes and serves as an expert witness in the prosecution of pyramid schemes. Mr. FitzPatrick is president of FitzPatrick Management Inc. in Charlotte, N.C.

For more information

Pyramid Scheme Alert - <http://www.pyramidschemealert.org/>

FitzPatrick, Robert and Reynolds, Joyce K. *False Profits: Seeking Financial and Spiritual Deliverance in Multi-Level Marketing and Pyramid Schemes*. Charlotte, NC, 1997, ISBN: 0-9648795-1-4. <http://www.falseprofits.com>

Carter, Ruth. *Behind the Smoke and Mirrors: Amway Motivation Organizations*. Backstreet Publishing, Orlando, FL, 1999. <http://www.backstreetpublish.com/AMOindex.htm>

Taylor, Jon M. *The Network Marketing Game*. King Alfred Press, Salt Lake City, UT, 1998. <http://www.whatisgood.com/nwm/nwmlds.htm>

Taylor, Jon M. *Product-Based Pyramid Schemes: When Should an MLM or Network Marketing Program Be Considered an Illegal Pyramid Scheme?* Provides a list of defining characteristics of a product-based pyramid scheme to enable an interested person to determine whether a particular venture is really just a disguised pyramid. View or download at: <http://www.pyramidschemealert.org/resources/ratools.htm>

Quackwatch by Dr. Stephen M. Barrett, M.D. - <http://www.quackwatch.com/index.html>

Federal Trade Commission Consumer Alert: The Bottom Line About Multilevel Marketing Plans - <http://www.ftc.gov/bcp/online/pubs/alerts/pyradalrt.htm>

Ohio Consumer Sales Practices Act - <http://www.ag.state.oh.us/agpubs/conslaws.htm>

2000-01 Council Leaders

Board of Trustees**Chairman**

Richard A. Mueller
Vice President Internal Audits
American Electric Power
Service Corp.
Columbus, Ohio

Vice Chairman

Glenn W. Soden
Associate Vice President and
Assistant Secretary
Nationwide
Columbus, Ohio

Secretary

J. Christopher Scott
Executive Vice President
Continental Auto Receivables, Inc.
Dublin, Ohio

Treasurer

Gary M. Sullivan, Jr.
Partner
Deloitte & Touche LLP
Columbus, Ohio

Harold C. Babson

Chairman, Business Management/
Office Administration
Columbus State Community College
Columbus, Ohio

Cathy Blackford

Executive Director
Builders Exchange of Central Ohio
Columbus, Ohio

Marie Bohatá

President, Czech Statistical Office
Prague, Czech Republic

R. Gregory Browning

President
Capital Partners
Worthington, Ohio

Thomas B. Courtice

President
Ohio Wesleyan University
Delaware, Ohio

Bjørn Erik Dahlberg

Dahlberg Consulting
Oslo, Norway

Mark A. Evans

Senior Vice President/Administration
and Planning
The Columbus Dispatch
Columbus, Ohio

Lawrence W. Forlenza

District Director
Merrill Lynch
Columbus, Ohio

Glenn W. Hammer

Vice President, Environment, Health
and Safety
Ashland Inc.
Columbus, Ohio

Mary S. Held

Director of Global Learning
Pathlore
Worthington, Ohio

Joseph C. High

Vice President Human Resources
Rockwell International
Milwaukee, Wisconsin

Fordham E. Huffman

Partner-in-Charge
Jones, Day, Reavis & Pogue
Columbus, Ohio

Pam Hurley

International Business Consultant
Hertfordshire, United Kingdom

Roy J. Lewicki

Dean's Distinguished Teaching Professor
The Ohio State University
Columbus, Ohio

William G. Martin

Of Counsel
Porter, Wright, Morris & Arthur
Columbus, Ohio

Tracy A. McPherson

Manager, Corporate Compliance
& Ethics Office
Honda of America Manufacturing, Inc.
Marysville, Ohio

Mark W. Meister

Vice President - Human Resources
and Chief Ethics Officer
The Lubrizol Corporation
Wickliffe, Ohio

Bill Rives

Program Chair for Finance and
Accounting
Franklin University
Columbus, Ohio

Samuel A. Shuman

Chairman
Speer Industries, Inc.
Columbus, Ohio

Senior Counselors

Charles A. Aldag

Special Advisor, Responsible Care
Initiative®
Chemical Manufacturers Association
Columbus, Ohio

Toshikata Amino

Professor, Kansai University
Executive Vice President (ret.)
Honda of America Manufacturing, Inc.
Tokyo, Japan and Plain City, Ohio

Rowland C. W. Brown

Former President/CEO
Online Computer Library Center
Columbus, Ohio

Robert L. Browning

Professor Emeritus
Methodist Theological School
Worthington, Ohio

Paul A. Donald

Chairman
Sencorp International
Columbus, Ohio

Executive Staff

David C. Smith

President
Columbus, Ohio



125 East Broad Street
Columbus, Ohio 43215-3605
USA
(614) 221-8661
FAX: (614) 221-8707

www.businessethics.org

The Council for Ethics in Economics acknowledges with
gratitude the generous support of its
Leadership Circle Members:

**Ashland Inc.
Jones, Day, Reavis & Pogue
Merrill Lynch**

The Council for Ethics in Economics seeks to build trust among
participants in economic life by strengthening honesty, respect for
persons, justice, and sustainable environmental practices.

Board of Trustees Mission Review Committee, 2000

The Council for Ethics in Economics is an
association of leaders in business, higher education, religion and other
professions working together to strengthen the ethical fabric of business
and economic life. The Council carries out its mission by identifying
and responding to issues important to the pursuit of ethical business, and
assists in the resolution of these issues.

We Welcome New Members. To receive Council information
and news of coming events, and to participate in our important work,
please call, write, e-mail or fax to learn how you and your organization
can work with us to help strengthen the ethical fabric of business and
economic life.

Ethics in Economics is published by the Council for Ethics in Economics.
Subscription is included in Council membership. *Ethics in Economics* seeks to
present diverse perspectives and foster discussion on issues related to applied
ethics. The opinions expressed do not necessarily reflect the opinions of Council
for Ethics in Economics trustees, staff, or members. Letters or other comments
are welcome.

Editor: David C. Smith
Issue Editor: Robert L. FitzPatrick

© 2001, Council for Ethics in Economics. Reproduction in whole or in part
without permission is prohibited.