

PROHIBIT PYRAMID PROMOTIONAL SCHEMES

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<http://www.house.mi.gov/hfa>

House Bill 5726 (H-1) as reported from committee
Sponsor: Rep. Eric Leutheuser

Analysis available at
<http://www.legislature.mi.gov>

House Bill 5727 (H-1) as reported from committee
Sponsor: Rep. Pamela Hornberger

House Bill 5728 (H-1) as reported from committee
Sponsor: Rep. Jeffrey R. Noble

House Bill 5729 (H-1) as reported from committee
Sponsor: Rep. Brandt Iden

Committee: Commerce and Trade
Complete to 4-12-18

BRIEF SUMMARY: House Bill 5726 would create a new act to prohibit a person from promoting or participating in a pyramid promotion scheme. The bill would create penalties for noncompliance; allow the attorney general to bring legal actions, undertake investigations, and impose fines; and allow for plans or operations that meet certain requirements.

House Bills 5727, 5728, and 5729 would make complementary amendments to the Franchise Investment Law, Code of Criminal Procedure, and Michigan Consumer Protection Act, respectively.

HB 5726 is tie-barred to both HB 5727 and HB 5729, and HBs 5727, 5728 and 5729 are each tie-barred to HB 5726. A bill that is tie-barred to another bill cannot take effect unless that other bill is also enacted.

Each bill would take effect 90 days after being enacted into law.

FISCAL IMPACT: House Bill 5726 would have an indeterminate fiscal impact on the state and on local units of government. House Bills 5727 and 5729 would have no fiscal impact on state or local governments. House Bill 5728 amends sentencing guidelines and would not have a direct fiscal impact on the state or on local units of government. (See ***FISCAL INFORMATION***, below, for further discussion.)

THE APPARENT PROBLEM:

Pyramid and chain promotions are currently illegal under state and federal law. In such a scheme, an individual is recruited into and pays to enter a program that promises future compensation. The future compensation is based not on the sale of actual goods or services, but simply on recruiting more individuals to join the program. Math aside, no such scheme can long exist, and the schemes are dangerous to current participants and potential recruits.

Some believe that Michigan's law regarding pyramid and chain promotions is not clear enough in delineating such a fraudulent scheme from a legitimate direct selling company. In a direct selling company, an individual receives compensation from selling a company's products or services outside the traditional retail setting, and can also receive compensation based on the recruitment and sales of other individuals. Legislation has been introduced to more clearly define a pyramid promotion scheme and provide for the attorney general to investigate and prosecute when violations are found.

THE CONTENT OF THE BILLS:

House Bill 5726

HB 5726 proposes a new act, the Pyramid Promotional Scheme Act, described below.

Prohibit Pyramid Promotion Schemes and Provide for Penalties

Under the Act, a person could not promote or participate in a ***pyramid promotional scheme***.

Pyramid promotional scheme would mean any plan or operation in which an individual gives ***consideration*** for the opportunity to receive ***compensation*** that is derived primary from recruiting other individuals into the plan or operation rather than from the sale or consumption of products and services by ultimate users.

Consideration would mean the payment of cash or anything of value or purchase of goods, services, or intangible property. Consideration would 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.

Compensation would mean a payment of any money, thing of value, or financial benefit conferred in return for inducing an individual to participate in a pyramid promotional scheme.

Any person that ***promoted*** a pyramid promotional scheme would be guilty of a felony punishable by imprisonment for not more than 7 years or a fine of not more than \$10,000 (per violation), or both.

Promote would mean to contrive, prepare, establish, plan, operate, advertise, or otherwise induce or attempt to induce an individual to participate in a pyramid promotional scheme.

A person that knowingly participated in a pyramid promotional scheme would be guilty of a misdemeanor punishable by imprisonment for not more than 90 days or a fine of not more than \$1,000, or both.

Attorney General Role and Responsibilities

If the attorney general (AG) had reasonable cause to believe that a person had engaged in or was about to engage in an act or practice that violated the Act, or any order issued under the Act, the AG could do any of the following:

- Issue a cease and desist order against any person engaged in the prohibited activities, directing the person to cease and desist from further illegal activities. The cease and

desist order would have to include its effective date, intent or purpose, and the grounds on which it is based.

- Bring an action in the circuit court of the county in which the violation is believed to have occurred, or in the Ingham County circuit court, to do any of the following:
 - Enjoin the acts or practices that violate the Act.
 - Enforce compliance with the Act or any order issued under it.
 - Recover a civil fine of not more than \$10,000 for each violation. The proceeds of any fine would be paid to the state treasurer for credit to the general fund.

A person aggrieved by a cease and desist order could obtain a review of the order in the Ingham County circuit court.

Upon a proper showing to the appropriate circuit court, a permanent injunction, temporary injunction, or restraining order could be granted and a receiver or conservator could be appointed for the person alleged to have violated the Act (or the assets of such a person). Additionally, upon proper showing by the AG, the circuit court could enter an order of rescission, restitution, or disgorgement directed to any person that had engaged in any act violating the Act or an order issued under it.

A circuit court could award the AG court costs and attorney fees. None of the above provisions would bar the AG or a prosecuting attorney from proceeding under any other provision of law against pyramid promotional schemes or any person involved with a scheme.

If the AG had reasonable cause to believe that a person had information or was in possession, custody, or control of any document or object that was relevant to an investigation or violation, the AG, or prosecuting attorney with permission or at the request of the AG, could serve on the person, before bringing any action in the circuit court, a written demand to appear and be examined under oath, and to produce the document or object for inspection and copying. The demand would have to include:

- Be served on the person in the manner required of service of process in Michigan.
- Describe the nature of the conduct constituting the alleged violation under investigation.
- Describe the document or object with sufficient definiteness to permit it to be fairly identified.
- If demanded, contain a copy of any written interrogatories.
- Prescribe a reasonable time at which the person must appear to testify, answer any written interrogatories, or produce the document or object, and advise the person that objections to or reasons for not complying with the demand may be filed with the AG, or with the prosecuting attorney, on or before that time.
- Specify a place for the taking testimony or production and designate the person that will be custodian of the document or object.

The Act would also require the demand to include a copy of provisions regarding noncompliance with the demand. Specifically, if a person objected to or failed to comply with the demand, the AG could file an action to enforce the demand in the circuit court where the person resided or maintained a principal place of business. Notice of hearing the action and a copy of all pleadings would have to be served upon the person, and the person could appear in opposition. If the court found that the demand was proper, that there was reasonable cause to

believe there is or was a violation of the Act, and that the information sought or document or object demanded is relevant to the investigation, the court would have to order the person to comply with the demand, subject to any demands it could prescribe. On motion by the person and for good cause shown, the court could make any further order in the proceedings that justice requires to protect the person from unreasonable annoyance, embarrassment, oppression, burden, or expense.

The AG or prosecuting attorney would have to keep any procedure, testimony taken, or material produced confidential before bringing an action against a person under the Act for a violation, unless confidentiality is waived by the person under investigation and the person who has testified, answered questions, or produced material, or unless disclosure is authorized by the court.

Allow Certain Plans or Operations

The Act would state that there is a rebuttable presumption that a plan or operation is not a pyramid promotion scheme if both of the following are satisfied:

- The plan or operation does not cause *inventory loading*.
- The plan or operation implements an *inventory repurchase program*.

Inventory would mean goods, including company-produced promotional materials, sales aids, and sales kits that a plan or operation requires participants to purchase.

Inventory loading would mean the requirement or encouragement by a plan or operation that its participants purchase inventory in an amount that exceeds the amount the participant could expect to resell for ultimate consumption or to consume in a reasonable time period, or both.

Inventory repurchase program would mean a program that does all of the following:

- Upon request, repurchases all current and marketable inventory in the possession of a participant within 12 months after the date of purchase, at not less than 90% of the original net cost, less setoffs, when the participant's business relationship is terminated.
- Clearly and prominently communicates to participants, before purchase, in recruiting literature, sales manual, or contracts with participants, what inventory is excluded from the repurchase program, including inventory that is classified as seasonal, discontinued, special promotion, is no longer within commercially reasonable use or shelf life, or is otherwise not eligible for repurchase.

Proposed MCL 455.2581 et seq.

House Bill 5727

HB 5727 would amend the Franchise Investment Law to delete existing language regarding the prohibition on offering or selling participation in a pyramid or chain promotion, the illegality of such a pyramid or chain promotion, and the Department of Attorney General's prohibition on accepting a filing for a franchise that involves such a pyramid or chain distribution.

Instead, the bill would prohibit the Department of Attorney General from accepting for filing a franchise that involves a pyramid scheme that violates the Pyramid Promotional Scheme Act.

MCL 445.1528

House Bill 5728

HB 5728 would amend the sentencing guidelines in the Code of Criminal Procedure to add the crime of establishing, promoting, or operating a pyramid promotional scheme as a class F felony against the public trust with a maximum term of imprisonment of 7 years.

The bill would also remove the existing sentencing guidelines for the crime of offering or selling a franchise through a pyramid or chain promotion under the Franchise Investment Law, which currently is a class D felony against the public trust that carries a maximum term of imprisonment of 7 years.

MCL 777.14h

House Bill 5729

HB 5729 would amend the Michigan Consumer Protection Act to update a reference within the Act's definition of "trade or commerce." Currently under the Act, trade or commerce does not include the purchase or sale of a franchise, but does include pyramid and chain promotions, as defined in the Franchise Investment Law.

The bill would instead state that trade or commerce does not include the purchase or sale of a franchise as defined in Section 2 of the Franchise Investment Law, but does include a pyramid promotional scheme that violates the Pyramid Promotional Scheme Act.

MCL 445.902

FISCAL INFORMATION:

House Bill 5726 would have an indeterminate fiscal impact on the state and on local units of government. Information is not available on the number of persons who might be convicted under provisions of the bill. New felony convictions would result in increased costs related to state prisons and state probation/parole supervision. In fiscal year 2017, the average cost of prison incarceration in a state facility was roughly \$37,000 per prisoner per year, a figure that includes various fixed administrative and operational costs. State costs for parole and felony probation supervision averaged about \$3,600 per supervised offender in the same year. New misdemeanor convictions would increase costs related to county jails and/or local misdemeanor probation supervision. The costs of local incarceration in a county jail and local misdemeanor probation supervision vary by jurisdiction. The fiscal impact on local court systems would depend on how provisions of the bill affected caseloads and related administrative costs. Any increase in penal fine revenues would increase funding for local libraries, which are the constitutionally designated recipients of those revenues.

HB 5726 would both permit and require the Department of Attorney General to undertake additional legal services associated with enforcing the regulation of "pyramid promotional

schemes.” The department reports that it cannot determine precisely what additional resources would be required to satisfy the requirements put forth in the bill. Should the department require additional personnel, the cost of an additional attorney FTE is approximately \$180,000.

ARGUMENTS:

For:

The package is a needed step to further clarify the difference between illegal promotional schemes and legitimate direct selling companies. Many direct selling companies—those in which independent consultants sell products or services outside traditional retail outlets—have successfully operated for decades. The consultants have realized additional incomes and social enjoyment from participation. These businesses will continue. Illegal schemes will be investigated and prosecuted, protecting both consumers who might become involved in such a scheme, and the legitimate direct selling companies who might suffer reputational impacts.

For:

House Bill 5726 is based on model legislation that has been adopted in numerous other states, and was adopted as suggested state legislation by the Council of State Governments.¹ It incorporates some of the best practices in direct selling. These best practices require operations to include a buyback program for goods not sold by program consultants and prohibit requiring consultants to buy goods in excess of what can be reasonably sold. Michigan should join the other states in adopting laws that separate legitimate businesses from bad actors within the system.

Against:

No arguments were offered in opposition to the bills.

POSITIONS:

A representative of the Department of Attorney General indicated support for the bills. (4-11-18)

Representatives of the following entities testified in support of the bills (3-20-18):

Direct Selling Association
Amway
American Communications Network
Mary Kay, Inc.
Southwestern Advantage

Legislative Analyst: Patrick Morris
Fiscal Analysts: Michael Cnossen
Robin Risko

■ This analysis was prepared by nonpartisan House Fiscal Agency staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.

¹ Prohibiting Pyramid Promotion Schemes, <https://www.csg.org/knowledgecenter/docs/ssl/Pyramid.pdf>