

THE PYRAMID PROBLEM:
REGULATING DIRECT SALES AT THE EDGES OF LABOR AND CONSUMPTION, 1972–1982

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On September 28, 1972 Walter Mondale stood before the U.S. Senate and declared the pyramid sales plan “*the* ‘consumer fraud problem of the 1970s.’”¹ The Democratic Senator from Minnesota claimed the U.S. was “in the midst of an epidemic of vicious chain selling enterprises, which [have] taken over \$300 million in investment money from the American public.” Pyramid sales organizations, according to Mondale, practiced:

A wide variety of deceptive, high-pressure sales techniques . . . to recruit new investors, including the planting of shills in the audience, who prominently display wads of large bills and promise the potential investor that the road to easy riches is at hand . . . with the result that the potential investors cannot make a rational choice.²

Americans across the country had fallen victim to schemes purporting to sell burglar alarms and long-distance calling cards, lease payphone booths, peddle membership in discount travel and purchasing clubs, and market various (often non-existent) consumer products. According to one estimate, American investors lost more than \$1 billion to Ponzi and pyramid schemes in 1976 alone.³

The U.S. already had some state-level regulations in place to police Ponzi schemes. As in Charles Ponzi’s plan to invest in international stamps in the 1920s, a Ponzi scheme recruited individuals to “invest” in an organization or security with the promise of unusually high interest, sometimes upwards of 100%. Early entrants into the scheme received the promised return, which

¹ Walter Mondale quoted in *Congressional Record: Proceedings and Debates of the 92nd Congress, Second Session*. 118, 25 (September 27, 1972–October 4, 1972): 32660–32662: 32660. Emphasis added. This phrase appears in the transcripts in quotations. The source of the quote may be William J. Casey, Chairman of the Securities and Exchange Commission, but is not indicated.

² *Ibid*, 32660.

³ Aggregate data for losses in pyramid schemes are difficult to find and only account for losses to schemes under investigation. Tamar Frankel estimated losses of \$1 billion in 1976 using data drawn from court cases. See Frankel, *The Ponzi Scheme Puzzle: A History and Analysis of Con Artists and Victims* (Oxford: Oxford University Press, 2012), 7.

created the illusion of success and legitimacy and hence attracted more participants. But the return came from funds contributed by subsequent investors rather than from real profits generated by the alleged company or security. As more individuals invested, the perpetrator—as well as those at the “top” of the pyramid—could make a tremendous amount of money before the scheme ran out of potential new investors or was exposed as a fraud. Pyramid sales schemes operated according to the same logic of continual recruitment, what attorneys and regulators called “geometric progression” or an “endless chain,” but under the guise of sales rather than investments. Because they related to trade rather than securities, pyramid sales schemes and Ponzi schemes had to be regulated separately.⁴

Pyramid sales schemes were difficult to regulate, however, because they resembled not only Ponzi schemes but also legitimate networked direct sales organizations.⁵ Pyramid schemes relied on many of the same recruiting and supposed compensation strategies. They employed language nearly identical to that used in marketing materials for Avon, Tupperware, and Amway. Pyramid schemes looked so much like networked direct sales firms that even high-level corporate executives and business associations in the direct sales industry—which had historically opposed government interference in the industry—supported Mondale’s efforts. President of the Direct Selling Association (DSA) J. Robert Brouse testified before the Senate that exploitative pyramid schemes

⁴ Ponzi schemes fall under the purview of the SEC as a form of investment fraud, while the FTC typically monitors pyramid schemes as consumer fraud or unfair competition. The SEC defines a Ponzi scheme as “an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity.” (<http://www.sec.gov/answers/ponzi.htm#PonziWhatIs>).

⁵ Direct sales firms do not sell products in physical stores. Rather, they rely on a salesforce of independent contractors called representatives, distributors, or, in Amway’s case, “Independent Business Owners” (IBOs). Distributors acquire goods from the corporation and resell them to customers at a profit. In networked direct sales firms (also called multilevel marketing), distributors earn additional income by recruiting or “sponsoring” others to sell under them as part of what the industry calls one’s “downline.” A sponsor receives an ongoing share of all his or her recruits’ sales, *plus* a share of sales made by anyone the recruit subsequently brings into the organization.

masqueraded as networked direct sales firms, which misled consumers and cast a shadow on members of the DSA.

Brouse feared, however, that legitimate direct sales firms would get caught up in anti-pyramid legislation, which coincided with other challenges to the legal status of the direct sales industry and its model of labor. In 1972, the Internal Revenue Service (IRS) contested the independent status of direct sellers, who the IRS argued should be reclassified as employees. In 1974, the Federal Trade Commission (FTC) conducted a four-year investigation of the Amway Corporation and its networked direct sales plan. States and individuals brought criminal suits against networked organizations and against individual participants.⁶ In the realm of popular culture, too, exposés from sources such as *60 Minutes*, *The Phil Donahue Show*, published personal accounts, and other media coverage raised questions about networked direct sales and its relationship to the public good, consumer rights, the state of the labor economy, and the materialism of American consumer culture.⁷ On one hand, direct sales firms flourished in the 1970s. Between 1969 and 1974, direct sales grew from \$3 billion in retail sales into a \$5 billion industry with a salesforce of two million in the U.S. On the other, greater success and visibility also brought about new scrutiny in the 1970s and 1980s as various legislators and government agencies tried to comprehend, regulate—and tax—direct sales firms.

⁶ Examples of state-level and civil cases include: *Lomax v. Norman Harry et al. and Amway, Inc.*, Supreme Court of New York, Appellate Division, Second Department. 119 A.D.2d 638, 501 N.Y.S.2d 84, 1986; *Amway Corporation v. State of Michigan*, Department of Treasury, Revenue Division, Revenue Commissioner Docket No. 105020, 176 Mich. App. 285, 438 N.W.2d 904, 1989; *Lockwood and Lockwood v. Larson and Amway Corporation*, Trial No. A-8200309, Court of Appeals, First Appellate District of Ohio, Hamilton County, Ohio, 1985. On *State of Wisconsin v. Amway Corporation, Inc.*, July 28, 1982. Kathryn A. Jones, *Amway Forever: The Amazing Story of a Global Business Phenomenon* (Hoboken: Wiley & Sons, Inc. 2011): 78–80.

⁷ Mike Wallace, “Soap and Hope,” *60 Minutes* (CBS News), January 1983. Audio-Visual Collection. LOC. On *The Phil Donahue Show* (1983) see Jay Van Andel, *An Enterprising Life* (New York: HarperCollins Publishers, Inc., 1988): 100–103. Steve Butterfield, *Amway: the Cult of Free Enterprise* (Boston: South End Press, 1985). Michael Moore mocks distributors’ mix of enthusiasm, optimism, and desperation in the deindustrializing Rust Belt. Michael Moore dir., *Roger and Me* (Warner Brothers, 1989).

Attempts to regulate direct sales as a mode of commerce and a category of work ultimately did more to legitimize networked direct sales organizations than undermine them. Mondale's 1972 Pyramid Sales Act (S.4043) was never enacted in part because Congress could not draft legislation both broad enough to tackle the pyramid scheme problem and also specific enough to exclude powerful, multimillion-dollar corporations like Avon. In 1979 the FTC declared that Amway was not merely a legal pyramid sales organization but the *model* of a legal pyramid sales firm. The DSA also defeated the IRS' attempts to reclassify direct selling as a form of taxable employment. Having withstood the scrutiny of the FTC and IRS, direct sales firms entered the 1990s with what executives could claim as an official stamp of approval from the federal government. Moreover, that approval carried with it a new set of legal and administrative parameters that protected multilevel sales firms and their use of semi-attached labor, and established legal grounding for the spread of "non-employment" practices into other segments of professional and service work as well.

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Pyramid-esque schemes have in various incarnations plagued investors and regulators for centuries. Colonial expansion and joint-stock companies in the seventeenth and eighteenth centuries created opportunities for speculative bubbles by encouraging individuals to invest in risky, sometimes fraudulent, ventures to develop foreign lands. The nineteenth century was rife with "robbing Peter to pay Paul" or "endless chain" schemes. In 1899, William "520 Percent" Miller's Brooklyn Syndicate bilked predominantly immigrant, working-class New Yorkers out of \$1 million by offering them a phony deposit certificate at a weekly interest rate of 10 percent. (The "520" nickname, a misunderstanding that 52 weeks of compound interest would yield 520 percent, signaled his victims' ignorance about finance and investing.) Twentieth-century speculators witnessed the worldwide scheme perpetrated by "Match King" Ivar Kruegar who in the 1920s convinced international magnates and Hollywood celebrities to invest in his global match monopoly.

Meanwhile, Kreugar was embezzling funds and counterfeiting foreign bills. And, of course, the eponymous Ponzi scheme of the 1920s turned the opportunity to profit from international stamp arbitrage into a national frenzy.⁸ Investment schemes and manias from Tulipmania in 1630 to the Bernie Madoff scandal in 2009 are old and common enough that many consider public financial markets and investment fraud as mutually constituted, even coeval.⁹

Despite the long history of pyramid schemes, there was in 1972 still no comprehensive federal law to address them. Nineteen states, including Pennsylvania, Washington, and Minnesota, had some form of law dealing with pyramid schemes but most states prosecuted perpetrators on charges of false advertising, mail or tax fraud, or money laundering. Even Madoff, mastermind behind the longest-running Ponzi scheme to date, was convicted on charges of wire fraud, perjury, and theft rather than under a law that prohibited pyramid or Ponzi schemes wholesale. The federal government could, and did, bring through the FTC or SEC a protracted legal investigation of operations it suspected of fraudulent activity. But it had no blanket power of injunction. An

⁸ Frank Partnoy, *The Match King: Ivar Krueger, The Financial Genius Behind a Century of Wall Street Scandals* (New York: PublicAffairs, 2009); Mitchell Zuckoff, *Ponzi's Scheme: the True Story of a Financial Legend* (New York: Random House, 2006); Donald Dunn, *Ponzi: The Incredible Story of the King of Financial Cons* (New York: McGraw-Hill, 1975).

⁹ On speculative bubbles: Peter M. Garber, *Famous First Bubbles: The Fundamentals of Early Manias* (Cambridge: MIT Press, 2000); Mike Dash, *Tulipmania: the Story of the World's Most Coveted Flower and the Extraordinary Passion it Aroused* (New York: Random House, 1999); Charles P. Kindleberger and Robert Z. Aliver, *Manias, Panics and Crashes: a History of Financial Crises*, Sixth Edition (London: Palgrave Macmillan, 2001); Charles Mackay and Joseph De la Vega in Martin S. Fridson, ed., *Extraordinary Popular Delusions and the Madness of Crowds and Confusión de Confusiones* (New York: John Wiley & Sons, Inc. 1996); William Deringer, "For What It's Worth: Historical Financial Bubbles and the Boundaries of Economic Rationality," *Isis* 106:3 (2015): 646–656. On fraud: David E. Sarna, *History of Greed: Financial Fraud from Tulip Mania to Bernie Madoff* (Hoboken: John Wiley & Sons, 2010); Arthur A. Leff, *Swindling and Selling: The Spanish Prisoner Con and Other Bargains* (New York: The Free Press, 1976); Jay Robert Nash, *Hustlers and Con Men: an Anecdotal History of the Confidence Man and his Games* (New York: M Evans & Co., 1976); Edward J. Balleisen, *Fraud: an American History from Barnum to Madoff* (Princeton: Princeton University Press, 2017); Stephen Mihm, *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States* (Cambridge: Harvard University Press, 2009); Richard Rayner, *Drake's Fortune: The Fabulous True Story of the World's Greatest Confidence Artist* (New York: Anchor Books, 2003). On speculation, gambling, and deception in American history see: Ann Fabian, *Card Sharps and Bucket Shops: Gambling in Nineteenth-Century America* (New York: Routledge, 1999); Karen Halttunen, *Confidence Men and Painted Women: A Study of Middle-Class Culture in America, 1830-1870* (New Haven: Yale University Press, 1986); Neil Harris, *Humbug: The Art of P.T. Barnum* (Chicago: University of Chicago Press, 1981); Jackson Lears, *Something for Nothing: Luck in America* (New York: Penguin, 2004); James W. Cook, *The Arts of Deception: Playing with Fraud in the Age of Barnum* (Cambridge: Harvard University Press, 2001); Steve Fraser, *Wall Street: America's Dream Palace* (New Haven: Yale University Press, 2008); Steve Fraser, *Every Man a Speculator: a History of Wall Street in American Life* (New York: HarperCollins, 2005).

individual could file suit against a suspected pyramid scheme. But even when an individual or state took “successful action against one [pyramid scheme],” as Washington State Attorney General Slade Gorton testified before the Senate in 1974, “the outfit would simply move across state lines and begin the same kind of activity someplace else.”¹⁰ Given their mobile and diffuse nature, pyramid schemes were, according to Minnesota Attorney General Warren Spannaus, “a national problem” and had to be regulated as such.¹¹

Mondale’s interest in pyramid schemes reflected his concern for consumer and investor rights and what he, along with the FTC, interpreted as a surge in pyramid and fraudulent investment schemes.¹² Citizens in the 1970s invested in operations like United Buyers Union, which ran a “plus income program” whereby participants obtained large discounts on goods and services by purchasing a club membership *plus* the opportunity to earn income by selling memberships to others. The discounts, if they even existed, were only incidental to organizations like United Buyers Union, which generated income from the continuous sale of club memberships. Between May and October of 1972, United Buyers recruited 5,000 consumers in the Los Angeles area who purchased more than \$2 million in memberships.¹³ A nearly identical operation called Galaxy Foods collected \$3.7 million in membership fees from 800 people on Long Island in 1973.¹⁴ The Bull Investment

¹⁰ Statement of Slade Gorton Attorney General, State of Washington, *Hearing Before the Subcommittee for Consumers of the Committee on Commerce United States Senate 93rd Congress, Second Session on S.1939*. July 10, 1974: 52.

¹¹ Statement of Warren Spannaus, Attorney General, State of Minnesota, accompanied by Jerome L. Getz, Special Assistant Attorney General. *Hearing Before the Subcommittee for Consumers of the Committee on Commerce United States Senate 93rd Congress, Second Session on S.1939*. July 10, 1974: 19. On the SEC, the FTC, and the challenges of combatting pyramid schemes see “Regulation of Pyramid Sales Ventures,” *William and Mary Law Review* 15:1, Article 6 (1973). <http://scholarship.law.wm.edu/wmlr/vol15/iss1/6>.

¹² It also coincided with a broader interest among Congress and bodies such as the SEC to develop a more robust legal, regulatory, and administrative scaffolding with which to protect consumer and investor rights. By the mid-1970s, the issue of corporate governance was at the center of the SEC’s reform agenda. Congress in particular was expanding its role in consumer advocacy with Mondale, a longtime advocate for consumers’ rights as a Senator and Attorney General of Minnesota, leading the charge. Brian R. Cheffins, “The History of Corporate Governance,” ECGI Working Paper No. 184/2012. January 2012. <http://ssrn.com/abstract=1975404>. Walter Mondale, *The Good Fight: a Life in Liberal Politics* (New York: Simon and Schuster, 2010); Steven M. Gillon, *The Democrats’ Dilemma: Walter F. Mondale and the Liberal Legacy* (New York: Columbia University Press, 2010).

¹³ Myrna Oliver, “L.A. Firm Accused of Pyramid Scheme in Suit by Younger,” *Los Angeles Times*. October 5, 1972: C1.

¹⁴ Will Lissner, “Pyramid Scheme Under Fire,” *New York Times*. December 16, 1973: 131.

Group—an apt name for the purveyors of bullshit coupon books—similarly swindled individuals in New Jersey, Pennsylvania, Connecticut, and Vermont.¹⁵

Alongside chain-letter-style discount clubs, investment clubs in the 1970s and 1980s transformed pyramid scheming into a middle-class social activity. In 1979, a reporter from the *Washington Post* attended a party for a scheme that, in the reporter’s words, was “sweeping through the fashionable homes of Washington’s black middle class.” Dr. Kenneth Smothers, a 34-year-old psychiatrist, had invited more than one-hundred people to his home to sell them on the Circle of Gold plan, through which each participant bought a list of twelve names for \$100 and recruited two friends, each of whom contributed \$100. The original investor kept \$50 from each of them, thus breaking even. The other \$50 went to the first name on his list. The original investor then added his own name to the bottom of the list. Theoretically, as one’s name moved up to the top, an investor stood to collect \$50 fees from an untold number of total strangers. Some in attendance at Dr. Smother’s party suggested that they did in fact receive money through the Circle of Gold. “Almost every night, promoter-investors gather over white wine and hors d’oeuvres and flip charts in the intimate setting of a private home,” the *Post* reporter observed, “waving envelopes stuffed with \$50 bills as to sell their friends and colleagues what, authorities say, is a highly questionable chain letter than not only may violate federal lottery and mail fraud statutes but inevitably picks a lot of pockets.”¹⁶

Investment clubs were such a problem that police in California began organizing raids on investment and pyramid “parties.” In 1980, Orange County police raided a meeting of participants in a scheme called “Speedy Seven.” Police seized \$41,000 in cash and checks that participants had

¹⁵ Ken Cruikshank, “Two Firms in Suit Charged with Pyramid Sales Fraud,” *The Hartford Courant*, May 23, 1974: 58. Kenneth Hooker, “Firm’s Officer Denies Pyramid Sales Claim,” *The Hartford Courant*, June 7, 1974: 13. Kenneth Hooker, “Court Orders Dealer Refunds in 2 Pyramid Sales Firms,” *The Hartford Courant*, October 22, 1974.

¹⁶ Art Harris, “Pyramid Scheme Promises Fast Cash: ‘Circle of Gold’ Plan Attracts D.C.’s Black Middle Class,” *Washington Post*, July 15, 1979: A1.

invested at that party alone.¹⁷ In March 1980, the *Los Angeles Times* reported that county police broke up six such gatherings in a single day, five of which had over one-hundred people present. Police Sergeant Romayne Shaw stated, “We’re getting 15 to 20 locations a day . . . We just can’t get to them all.” Lieutenant William Mossman claimed his office received over three-hundred calls a day about pyramid schemes, chain letters, and investment club parties.¹⁸ Detective Jeff Richards of the Burbank Police Department even fielded a call from an angry husband: “Hey,” the caller shouted at Richards, “my wife just pulled all our savings out of the bank and went off to a pyramid meeting. What are you going to do about it?”¹⁹

What Mondale intended to do was make all pyramid schemes patently illegal at the federal level. The proposed Pyramid Sales Act of 1972—and revised versions S.1939 in 1973 and S.1509 in 1975—would have attached civil and criminal penalties to those who operated the scheme and required participants to pay restitutions to any person whom they directly recruited into the organization.²⁰ The bill passed the Senate but failed to make it beyond the House Committee on Commerce. The obstacle, Mondale found, was the lack of clarity around what separated a legitimate pyramid plan from an illegitimate one. He acknowledged that not all direct sales organizations, not even all networked ones, were fraudulent. The challenge was to draft a law broad enough to effectively prohibit pyramid schemes without also hindering valid commercial operations.

Brouse and other members of the DSA were acutely aware that the Pyramid Sales Act could “inadvertently adversely affect legitimate business enterprises.”²¹ Counsel to the International

¹⁷ Gary Jarlson, “Deputies Raid ‘Speedy Seven’ Game,” *Los Angeles Times*. June 3, 1980: OC_A1.

¹⁸ Richard West, “Police Planning New Raids on Illegal Pyramid Meetings,” *Los Angeles Times*. May 22, 1980: A3.

¹⁹ Richard West, “Pyramid Scheme Sweeping California,” *Los Angeles Times*. May 21, 1980: B1.

²⁰ Senate Bill 1939, *Congressional Record: Proceedings and Debates of the 93rd Congress*, First Session. 119, 14 (May 30, 1973–June 6, 1973): 17860-17866; Senate Bill 1509, *Congressional Record: Proceedings and Debates of the 94th Congress*, First Session. 121, 9 (April 17, 1975–April 24, 1975): 1363.

²¹ Statement of J. Robert Brouse, President, Direct Selling Association, Washington, D.C. accompanied by Alan Luce, Associate Legal Counsel. *Hearing Before the Subcommittee for Consumers of the Committee on Commerce United States Senate 93rd Congress, Second Session on S.1939*. July 10, 1974: 64.

Franchise Association Phillip Zeidman and McDonald's Vice President Normal Axelrad were particularly concerned about the "lack of distinction" between pyramid operations and franchising. "That lack of distinction," Zeidman testified in support of the Act, "is sometimes seen in attitudes by journalists, by the media, by the consuming public, and all too often by State legislatures."²² Fraudulent sales operations, from that point of view, damaged the reputation of the franchise system as a whole. Axelrad insisted that franchise companies "have nothing in common" with pyramid schemes. Nevertheless, "the guilty and the innocent are . . . too often tarred with the same brush. . . . As each new pyramid and multi-level distribution fraud is reported, additional negative public relations follows."²³ Corporate leaders' support for the Pyramid Sales Act reflected another concern as well. Zeidman, along with executives from other business associations, favored federal action as an alternative to individual state-level regulations. "The burden which proliferating and inconsistent State legislation can place upon an expanding franchisor . . . faced with a hodgepodge" of state laws, he testified, rendered Federal action "most desirable."²⁴

To business leaders as well as Mondale, the Pyramid Sales Act was necessary because the American public was being misled and could not easily discern between legitimate pyramid sales plans and fraudulent pyramid schemes. The problem, however, was that neither could Congress. Legislators could recognize obvious cases of fraud, for example operations that in fact had no product to sell. But few cases were so clear cut. Given that pyramid schemes relied on many of the same recruiting, compensation, and marketing strategies as those practiced by Avon, Tupperware, and Amway—all multimillion-dollar businesses—legislators ran the risk of condemning as fraudulent methods of persuasion and commission-based sales work common not only to direct

²² Statement of Philip Zeidman, Washington Counsel, International Franchise Association accompanied by Norman Axelrad, Vice President, MacDonaldis's Corporation, Oak Brook, Ill. (sic) *Hearing Before the Subcommittee for Consumers of the Committee on Commerce United States Senate 93rd Congress, Second Session on S.1939*. July 10, 1974: 41.

²³ *Ibid*, 44-45.

²⁴ *Ibid*, 42.

sales firms but also to many American corporations in the late twentieth century. The Pyramid Sales Act put politicians in the dangerous position of having to identify at what point the rules of competitive capitalism turned into exploitation, which, ultimately, legislators were either unable or unwilling to do.

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The Pyramid Sales Act suffered from lack of clarity about precisely what qualified as an illegal pyramid scheme. Ultimately, that guidance came from two Federal Trade Commission decisions: *In the Matter of Holiday Magic, Inc.* in 1974 and *In the Matter of Koscot Interplanetary, Inc.* in 1975. The FTC began investigating Holiday Magic and Koscot Interplanetary—which purported to sell, respectively, cosmetics and home care products, and cosmetics through a multilevel sales plan—in 1970, approximately the same time Mondale was drafting the Pyramid Sales Act. Whereas Mondale saw the pyramid problem as an issue of consumer rights, the FTC saw *Holiday Magic* and *Koscot* as matters of free trade. The FTC’s job was in this regard far simpler than Congress’. The FTC investigated specific organizations authorities suspected were engaged in fraudulent activity. Congress, by contrast, had to draft legislation capable of prohibiting or policing cases in the future. Doing so required legislators to create a clear, specific legal definition of a pyramid scheme, a definition which did not previously exist. To condemn Holiday Magic and Koscot, the FTC merely had to determine whether each was guilty of violating the principles of free trade. But in so doing, the FTC created what Congress could not—legal guidelines through which to determine what qualified as a deceptive multilevel sales plan.

Although the FTC suspected and alleged that Holiday Magic and Koscot were pyramid schemes, these cases were at root about price fixing and price discrimination, both claims relatively easy to prove. Holiday Magic and Koscot sold goods to participants, who then resold those goods to consumers at a price set by the corporation (as opposed to a “suggested retail price”), which the

court deemed price fixing and a violation of Section Five of the Federal Trade Commission Act. Within each firm, participants were divided into ranks. Holiday Magic participants were organized in a hierarchy that progressed from the entry-level “Holiday Girl” or “Organizer” to “Master” to “General.” The corporation sold goods to Generals and Masters as a steeper discount than Holiday Girls received, which was a form of price discrimination according to the Robinson-Patman Act, or Section Two of the Clayton Act of 1936.

Throughout the Holiday Magic investigation, however, the FTC identified several characteristics that would become central to the Commission’s definition of illegal pyramid activity. The FTC noted that Holiday Magic’s profit, and that of distributors, was linked primarily to recruitment rather than sales. In most direct sales firms, participants advanced through the ranks by meeting a combination of recruitment and sales quotas. In Holiday Magic, one advanced from Holiday Girl to Master based on either a \$3,000 lump-sum fee or by purchasing \$5,000 worth of cosmetics and home care products from Holiday Magic. Holiday Magic encouraged distributors to invest the lump sum by setting it \$2,000 below the product requirement, which to the FTC was evidence that the organization emphasized recruiting over sales. Participants who paid a substantial up-front fee could bypass the lower-level requirements entirely and enter directly at the higher, and strangely militaristic, Master or General level. One could rise through the organization, in other words, without necessarily selling any products.²⁵

The FTC also objected to the added, non-sales-related fees Holiday Magic charged participants as they moved up the ranks. At the Master level, one purchased \$250 worth of new sales aids. As a General, one paid to complete a special training course. Additionally, when one advanced to the General level, she broke away from her sponsor to be the head of her own organization. To

²⁵ *In the Matter of Holiday Magic, Inc. et al. Order*. Docket 8834. Complaint, January 18, 1971–Decision, October 16, 1974. Holiday Magic was founded in 1964 by William Penn Patrick. In 1966, Holiday Magic reported monthly revenue in excess of \$2 million.

compensate her sponsor for this separation, the new General paid her former sponsor a “Release Fee” of \$2,500 and agreed to recruit a “Replacement Master” to take her place in the former sponsor’s organization. This triggered another round of fees, as the Replacement Master paid the lump-sum, purchased sales aids, and attended a training. All this money changed hands, the FTC noted, independent of sales.

On October 15, 1974 the court ordered Holiday Magic to “cease using its open-ended, multilevel marketing plan . . . [and] to make refunds to requesting distributors of monies unlawfully obtained.”²⁶ The term “pyramid scheme,” however, is notably absent from the FTC’s Final Decision against Holiday Magic. With no federal statute against pyramid schemes, nor any legal precedent whereby the FTC could determine if Holiday Magic was one, the FTC could only charge that Holiday Magic’s multilevel marketing plan made false claims about how easy it was to recruit people and about the likelihood of making gobs of money through an “endless chain” of recruiting, or what the Commission called “geometric progress.” The Commission reasoned that geometric progression was a mathematical impossibility because at some point the pool of available recruits dried up. With profits linked to recruiting, those who joined Holiday Magic early had a chance to build a sizeable downline, and therefore make significant money. But those who joined later had virtually no chance at all. Mondale made that point before the Senate: “if one person recruited six ‘friends’ into his scheme, and if [each] friend obtains six more friends, and if this process were repeated for a total of nine times, the number of people in the chain would total 10,077,696.”²⁷ Concluding that endless recruiting was impossible, the FTC decided that any claims to the contrary were therefore misleading.

²⁶ Ibid.

²⁷ Mondale, *Congressional Record* (1972).

Although *Holiday Magic* did not condemn pyramid schemes wholesale, it did differentiate multilevel marketing plans based on sales from those based on recruiting, and established that the latter were inherently deceptive. *Holiday Magic* also facilitated the FTC's subsequent case against Koscot Interplanetary, short for "Kosmetics for the Communities of Tomorrow." Koscot founder Glenn Turner had been a distributor with Holiday Magic and modeled his organization in its image. Even without the *Holiday Magic* precedent, however, Koscot was a clear case of fraud. Financial statements showed that one hundred percent of the company's revenue came from recruiting because, for the entire first year of its operation, Koscot did not actually have any cosmetics (or "kosmetics") to sell. Even in the second year, Koscot reported \$2.7 million in revenue from recruitment compared to a measly \$255,000 in gross product sales. Between 1967 and 1972, retail sales never accounted for more than forty-two percent of annual revenue. Distributors testified that Koscot was regularly unable to fulfill product orders. Inventory accounting substantiated those claims. Between 1969 and 1973, the value of finished goods Koscot kept on hand was consistently less than that due to distributors. The ratio of goods on hand to outstanding orders grew more distorted every year. By 1973, Koscot had only enough inventory to satisfy fifteen percent of outstanding orders due to distributors.²⁸

The FTC's case against Koscot was especially strong because the organization had already filed bankruptcy in July 1972. Furthermore, the bankruptcy had triggered state-level class action proceedings against Glenn Turner Enterprises, of which Koscot was a subsidiary, in Pennsylvania, criminal proceedings in Florida, and a separate SEC allegation of securities fraud. Facing several pending lawsuits, Turner and his associates declined to testify before the FTC out of fear their statements would be used against them in subsequent criminal trials. Turner in fact ran a chain of

²⁸ *In the Matter of Koscot Interplanetary, Inc. et. al. Order*. Docket 8888. Complaint May 24, 1972—Final Order November 18, 1975: 1120.

schemes in addition to Koscot. He sold distributors the right to market a self-improvement course called “Dare to Be Great, Inc.,” which garnered press attention as emblematic of widespread pyramid scheme activity in the 1970s.²⁹ Turner operated a discount membership club called “Kash is Best” and a number of affiliated organizations. By the end of 1972, he had investments in at least twelve different corporate entities, from which Turner also embezzled money through weekly transfers to Glenn Turner Enterprises.

Taken together, Turner’s notoriety, Koscot’s significance as representative of a larger problem facing the American public, and its clear status as fraudulent made the FTC’s job an easy one. In November 1975, the court declared that “the sales of [Koscot] cosmetics was merely incidental to the marketing of distributorships.” This was an important development in the FTC’s efforts to construct a legal definition of a pyramid scheme. *Holiday Magic* had declared organizations based on “geometric progress” inherently deceptive. *Koscot* pushed that decision further by establishing that the hallmark of a pyramid scheme was that its primary source of revenue came not from selling retail products but from selling “the right to sell a product.” In all future cases, the legality of any multilevel sales organization would be judged by that standard.

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While authorities investigated Koscot and Holiday Magic, the FTC was also building a case against the Amway Corporation. Over several years, it collected complaints from active and former distributors about the corporation’s business practices and marketing claims, and about alleged unethical behavior from recruiting distributors. In 1974, the FTC, which by that time had a clear set of guidelines with which to identify fraudulent pyramid sales and what authorities considered a strong case against Amway, initiated an official investigation into the \$200 million multilevel

²⁹ In September 1975, Turner and three former associates pleaded no contest to federal misdemeanor charges of violating SEC regulations. Unknown, “Turner Fined \$5,000 in Pyramid Scheme,” *Los Angeles Times*, September 17, 1975: A2. Unknown, “‘Pyramid’ Promoter Among 30 Indicted,” *New York Times*, June 13, 1972: 19.

marketing giant. But attorneys arguing on behalf of Amway now had *Koscot* on which to base their defense. Amway's attorneys could refer to *Koscot* as the definitive example of a pyramid scheme and then point to all the ways Amway diverged from it. If *Koscot* provided a set of rules with which to determine what a pyramid scheme was, the *Amway* decision established criteria by which to determine what a pyramid scheme was not.³⁰

Amway's attorneys argued that the Amway Sales Plan encouraged recruiting but never to the exclusion of sales. Whereas *Koscot* and Holiday Magic charged new distributors sizeable up-front fees, new Amway distributors purchased only a \$15 sales kit. Attorneys also highlighted a number of safeguards in place to keep distributors engaged in selling products to retail customers. First, Amway required distributors to buy back unused products from their recruits upon request, which discouraged sponsors from pressuring recruits to buy an unmanageable amount of inventory to boost the sponsor's sales figures; distributors called it "inventory loading." Second, each Amway distributor was required to sell at wholesale or retail at least seventy percent of purchased inventory, meaning that a distributor could not meet the sales requirement for advancement simply by purchasing product for his or her personal use. This "seventy-percent rule," Amway's attorneys argued, made a "buy-in" path to advancement, like that available in Holiday Magic, impossible. Third, each Amway distributor was required to make at least one retail sale to each of ten different customers per month. The buy-back, seventy-percent, and ten-customer rules, attorneys claimed, specifically deterred distributors from engaging in recruiting alone.

The Commission ultimately determined that Amway did not meet the *Koscot* criteria. Given Turner's reputation as a criminal, it was hardly difficult to compare favorably. Amway was, however, found guilty of price fixing and misrepresenting potential income. As a result, Amway changed some

³⁰ *In the Matter of Amway Corporation, Inc. et al. Final Order*. Docket 9023. Complaint March 25, 1975—Final Order May 8, 1979.

corporate policies, most notably to include in recruiting literature actual average earnings figures and a statement to clarify that the earnings claims made by some distributors were illustrative rather than representative. Amway also changed its pricing policy by replacing the fixed retail list price with a suggested one. Yet, in general, Amway withstood the scrutiny of the FTC without having to make any major changes to its business plan, sales strategies, or recruiting practices.

Moreover, the FTC provided legal verification that Amway could use to combat popular perceptions that it was not a legitimate business. The FTC decision clearly stated that the “Amway Sales and Marketing Plan is not an illegal ‘pyramid scheme.’” Based specifically on the buy-back, seventy-percent, and ten-customer safeguards, the FTC determined that the “Amway plan is significantly different from the pyramid plans condemned in *Koscot* . . . [and] *Holiday Magic*. Specifically, the Amway Plan is not a plan where participants purchase the right to earn profits by recruiting other participants, who themselves were interested in recruitment fees rather than the sale of products.”³¹ By positioning Amway in contradistinction to *Koscot*, Amway’s attorneys not only evaded potential regulatory penalties but also established Amway as the new archetype for a legal pyramid sales operation. In fact, the FTC declared the set of safeguards Amway put in place, which came to be known as the “Amway Rules,” the criteria by which to determine a legal networked organization.³²

In some ways, however, Amway and *Koscot* were remarkably similar. Each employed the high-pressure sales techniques and exaggerated earnings claims that Mondale saw as a danger to

³¹ Ibid.

³² According to the FTC, “In *In re Amway Corp.* . . . the FTC distinguished an illegal pyramid from a legitimate multilevel marketing program.” Yet, while the Amway rules have functioned as a guideline, they do not in and of themselves determine legality. In *Webster v. Omnitrition Int'l, Inc.*, for example, the court noted the “‘70% rule’ and ‘10 customer rule’ are meaningless if commissions are paid based on a distributor’s wholesale sales (which are only sales to new recruits), and not based on actual retail sales. The court also noted that an inventory buy-back policy is an effective safeguard only if it is actually enforced.” *Webster v. Omnitrition Int'l Inc.*, 79 F.3d 776, 781-82 (9th Cir. 1996), cert. denied, 117 S. Ct. 174 _ U.S.) (1996) cited in Debra Valentine, “Pyramid Schemes,” presented at International Money Funds Seminar on Current Legal Issues Affecting Central Banks. Washington DC. May 13, 1998. <https://www.ftc.gov/public-statements/1998/05/pyramid-schemes>

consumers. The FTC hearings investigated such practices at length through testimony from active and former Amway distributors, many of whom accused Amway of questionable business practices. Several distributors testified they had been instructed not to use the name “Amway” in their initial recruiting pitch. Distributors recognized that many Americans had preconceived notions that Amway was not lucrative or was a pyramid scheme. Amway distributors also had a reputation as pests who harassed friends into doing business with them. To avoid those negative connotations, distributors often lured prospects to an Opportunity Meeting with a vague investment opportunity, only to reveal later that the opportunity was Amway. Distributors testified that after convincing friends to attend an Opportunity Meeting, it was common practice to insist on picking them up in case they had second thoughts, or even unplug the phone so they could not cancel. Others suggested that distributors went to great lengths to present a false image of the wealth they gained selling Amway. Distributor William Stone was personally on the verge of bankruptcy but scheduled his “prospect meetings” at the yacht club restaurant Pier 66 in Ft. Lauderdale to create the illusion that he was a wealthy member. Yet, while putting on airs or unplugging the phone pushed the boundaries of ethics in business, they were not technically illegal.

Amway distributors overwhelmingly testified that, just as Mondale suspected, Amway recruiting relied on psychologically and emotionally laden tactics that clouded participants’ ability to make a rational consumer choice. Nancy Johnson had previously declined several invitations to join Amway. But when her minister called her at home and asked if she could use a little extra money, Johnson found herself unable to politely refuse the leader of her church. After several months as a distributor, Johnson complained to her sponsor that holding multiple Opportunity Meetings a week cost her more in babysitting fees than she earned. Her sponsors, Mr. and Mrs. Biddle, told her:

You have two choices in life, involving your children. Now, a child depending on age from seven to nine o’clock at night is going ... to sleep and you have already cared for them during the day ... Now you have the choice that you can let little Johnny grow up and tug on your

apron string one day and say, ‘Why can’t I go to college?’ and ... you can tell little Johnny, ‘Well, son, I am sorry you can’t go to college, but I want you always to remember that I love you so much that I stayed home and watched you sleep.’ ... or you could choose another way of life and afford the expense at the present time for babysitters, get out, work the business, so that you will be able to afford the things as your children grow up that they need, such as education.³³

To keep her committed to her Amway distributors despite financial losses, the Biddles’ played on Johnson’s sense of herself as a mother and desire to provide for her children. This was a common tactic among Amway distributors and, even more striking, for Johnson herself. “I have heard other distributors state it,” she testified, “It was a story that was told over many times by many people and I told it over myself.”³⁴

The Commission acknowledged that networked direct sales organizations resorted to social pressure and emotional manipulation that preyed on participants’ desires and insecurities. From the corporations’ perspective, such practices reflected the excesses of a handful of rogue distributors. Whether coming from corporate instruction or a few bad apples, whatever emotional, psychological, or social harm networked direct sales organizations like Amway may have caused, those were not the kinds of harms the FTC was designed to remedy. While courts could assess Amway’s legality, they could do little to tackle the problems of coercion and manufactured consent that, while perhaps more obvious in networked direct selling, were present in most forms of salesmanship.

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Over the course of the 1970s, the U.S. Senate attempted to regulate direct sales as a form of salesmanship. The FTC tried to prosecute direct sales firms for violating principles of free trade and truth in advertising. While Congress and the FTC presumed there was something wrong with the way direct sales firms engaged in commerce, U.S. tax authorities recognized something about direct

³³ Nancy Johnson quoted in *Official Transcript of Proceedings Before the Federal Trade Commission, Docket No. 9023, In the Matter of Amway Corporation, Inc.* May 25, 1977: 1069. FTC.

³⁴ *Ibid*, 1069.

sales firms that Mondale and the FTC missed—direct sales firms were consumer organizations but also employers. Although firms like Avon and Amway distributed goods outside the conventional retail channel, their sales and marketing strategies were not significantly different from those practiced by other manufacturers or retailers. The direct sales industry’s most significant contribution to the history of American capitalism, for good or ill, was its model of labor.

Direct sellers had fallen under the classification of independent contractor since the 1930s when the National Association of Direct Selling Companies adopted that label to exempt direct sales work from the Social Security and Fair Labor Standards Acts enacted as part of the New Deal.³⁵ By the 1970s, however, U.S. tax authorities doubted whether independent contractor status accurately captured the relationship between direct sales firms and distributors. Were direct sellers truly independent workers, or was the label of independent contractor merely a convenient way for direct sales firms to avoid paying employment taxes?

In 1972, the U.S. Department of the Treasury pursued Queen’s-Way to Fashion, Inc. for unpaid employment taxes. Queen’s-Way, a direct seller of women’s apparel, was founded in 1952 by Mabel Westerberg. At issue in the Queen’s-Way case was whether thousands of Queen’s-Way distributors identified as independent contractors ought to rightly be considered employees, in which case their commission would be considered “wages” subject to the Federal Insurance Contribution Act (FICA), the Federal Unemployment Tax Act (FUTA), and the IRS statute on the Collection of Income Taxes as a Source of Wages. If direct sellers were employees who received a taxable wage, Queen’s-Way was liable for \$2.4 million in unpaid employment taxes for 1968, 1969, and 1970.³⁶

³⁵ See Chapter One.

³⁶ *Aparacor, Inc., Formerly Queen’s-Way to Fashion, Inc. v. the United States*, 556 F.2d 1004, Federal Circuit 1977.

The IRS did reclassify Queen’s-Way distributors and issued a Revenue Ruling against the firm, which culminated in a five-year process of appeals. DSA President Neil Offen described *Queen’s-Way* as “the biggest issue [facing the direct sales industry] in the early 1970s.” “When the IRS started to attack the independent contractor status of salespeople” it threatened, according to Offen, “the very lifeblood of the industry.” Just as direct sales executives in the 1930s interpreted Social Security and minimum wage laws as detrimental to the industry’s model of labor management, executives in the 1970s understood that the Queen’s-Way decision threatened to fundamentally alter the status of direct sales firms as employers. If sellers were reclassified as employees, direct sales firms would be liable for employment taxes and potentially medical, retirement, and other benefits. Executives might have to restructure their firm’s entire labor management and compensation strategy. The tax and employment status of direct sellers, in Offen’s words, “really was a life-and-death issue for the industry.”³⁷

The Queen’s-Way case extended from a long history of contest over the employment status of independent and traveling salespeople and the meaning of employment more broadly.³⁸ In the late 1930s and 1940s several legal and legislative challenges questioned the independent status of salespeople as it related to income and employment taxes, especially social security. The U.S. government, as well as the courts, traditionally judged sellers’ employment status according to a common law test based on a conception of employment as a master-servant relationship. The 1936 Treasury and Employment Tax Regulations characterized the employer-employee relationship as one in which “the person for whom services are performed has the right to control and direct the individual who performs the service, not only as to the result to be accomplished by the work but

³⁷ Neil Offen quoted in Robert R. Morris, *Direct Selling Association, 1910–2010: 100 Years of Connecting People, Products and Opportunity* (Washington, D.C.: Direct Selling Association, 2014), 64, 67.

³⁸ See Jean-Christian Vinel, *The Employee: a Political History* (Philadelphia: University of Pennsylvania Press, 2013). Eileen Boris, *Home to Work: Motherhood and the Politics of Industrial Homework in the United States* (Cambridge: Cambridge University Press, 1994).

also as to the details and means by which that result is accomplished.”³⁹ Traveling salespeople, by that measure, had too much autonomy to fall under the common-law definition of employee. In 1939, however, the Social Security Board lobbied Congress to revise that definition so individuals like traveling and insurance salespeople could participate in Social Security. The Board, which was intent on maximizing Social Security coverage, insisted that “persons who furnish primarily personal services” were “for all practical purposes” employed by a firm. Congress disagreed and endorsed the previous understanding of traveling salespeople as outside the bounds of the master-servant test.⁴⁰

Congress and the courts typically upheld the common-law definition of employment, but now always. In 1943, *American Oil Co. v. Fly* reaffirmed that commission salespeople were independent contractors based in part on the Social Security Board’s failed attempt to reclassify them. “In 1939 an attempt was made in Congress,” the court noted, to “depart[] from the master and servant test; its defeat must be taken as . . . Congressional acquiescence to that test.”⁴¹ In 1945, Mrs. Rambin, an Avon representative, petitioned the Bureau of Old-Age and Survivors Insurance to have her wage records revised to include her Avon commissions. When the Appeals Council of the Federal Security Agency declined her request, Rambin sued the Federal Security Administrator who supervised the case. A U.S. District Court in Louisiana upheld the Agency’s original decision on the grounds that Rambin was not an employee and Avon had not paid Social Security taxes on her behalf.⁴² In *NLRB v. Hearst*, by contrast, the courts ruled that newsboys, who performed work comparable to commission-based salespeople, *were* employees for the purposes of social security. In

³⁹ Regulations 90, Article 207: Wages. XV-39-8324. SST 42 in Internal Revenue Bulletin, Cumulative Bulletin XV-2. (July-December, 1936), 418.

⁴⁰Quoted in John E. North, “The Employment Tax Morass,” *Creighton Law Review* 11 (1978): 775-806: 779. I draw heavily from North’s historical review on employment law and case law citations. Also Hale E. Sheppard, “Direct Sellers Hit by IRS Worker-Classification Audits: An Analysis of the Obscure Rules and Strategies Applicable to These Workers,” *Taxes—The Tax Magazine*. August 2012: 45-59.

⁴¹ *American Oil Co. v. Fly* No 10324. 135 F.2d (1943): 493.

⁴² *Rambin v. Ewing*, 106 F. Supp. 268 (W.D. La. 1952).

the case of newsies, the court emphasized the intent of the Social Security Act over the question of supervisory control that defined the master-servant relationship.⁴³

Throughout the 1940s, courts heard similar challenges to the status of coal truckers and coal unloaders, furniture truckers, band musicians, and homebased garment workers. In those cases—for example *United States v. Silk*, *Harrison v. Greyvan Lines Inc.*, *Bartels v. Birmingham*, and *Walling v. American Needlecrafts*, respectively—courts considered the issue of control and also asked new questions about the “economic reality” of those jobs, including: how central the job was to the main operations of the business, whether the individual invested money and was responsible for his own expenses, and whether the individual or corporation bore most of the risk related to profit and loss.⁴⁴ Even President Truman weighed in on the independent contractor question. When Congress passed, against Presidential Veto, a Status Quo Amendment in 1948 reaffirming the common law control test, Truman objected that such a move would deprive thousands of commission and life insurance salespeople of social security.⁴⁵

With the Social Security Amendments of 1950, the Social Security Board finally succeeded in extending coverage to full-time commission salespeople provided they worked exclusively for a single firm, which many direct sellers did not. The 1950 amendments addressed the overly-narrow definition of taxable wage labor established in the 1936 Social Security Act, which had created huge gaps in coverage. The bill extended coverage to more than nine million Americans including domestic workers, agricultural workers, and employees in U.S. territories, among others. It also extended coverage to four-hundred thousand commission-based workers who fell outside the

⁴³ *NLRB v Hearst Publications, Inc.*, 322 U.S. 111 (1944).

⁴⁴ *United States v. Silk* 331 U.S. 704 (1947). *Harrison v. Greyvan Lines* 329 U.S. 709 67 S.Ct. 369 (1946). *Bartels v. Birmingham* 332 U.S. 126 (1947). *Walling v. American Needlecrafts* 139 F. 2d 60 (1943). *United States v. Silk Harrison* 331 US 704 67 S.Ct.1463 (1947).

⁴⁵ *Hearings Before House Ways and Means Committee on H.R. 2893*, 81st Cong., 1st Session. 1087-88 (1949) cited in North, “The Employment Tax Morass.” See Eileen Boris, *Home to Work*, 270-286.

common law definition of employment. The 1950 amendments did not, however, introduce a new, broader definition of employment. Rather, it provided an exception to the common-law definition for full-time insurance salespeople, agent-drivers and commission-drivers, and wholesale salespeople. Congress subsequently enacted the Social Security Self-Employment Tax, which established that all non-employee commission salespeople could also be covered.⁴⁶

Even after 1950, however, the employment status of commissioned salespeople remained contested and inconsistent. The 1950 amendments applied to FICA but not FUTA. Commissioned salespeople were not covered by FUTA until 1970. Moreover, neither the Social Security Amendments nor the Self-Employment Tax established clear guidelines on how the IRS was to ensure that corporations and self-employed individuals properly computed, reported, and paid those additional taxes. The outcome, according to one legal scholar, was an “employment tax morass,” which resulted in a decades-long “enforcement holiday.” Between 1950 and 1969 authorities pursued the IRS’ Revenue Rulings regarding the new Social Security and Self-Employment Tax rules in only two cases that dealt with commission salespeople other than insurance agents.

Following a period of lax execution, the IRS’ interest in Queen’s-Way represented a shift in the IRS’ enforcement policy. After the FUTA requirements were broadened in 1970, the IRS issued more than thirty Revenue Rulings to review previous cases in which workers were classified as independent contractors. One scholar of employment tax law has speculated that IRS authorities in the early 1970s suspected that independent or self-employed persons were not reporting their earnings accurately or consistently, and therefore not paying sufficient income tax.⁴⁷ Were that the case, the IRS could have tried to educate self-employed individuals about their tax responsibilities or

⁴⁶ Social Security Act Amendments of 1950. Public Law 734. 81st Congress. Chapter 809, 2d session. H.R. 6000. Wilber J. Cohen and Robert J. Meyers, “Social Security Act Amendments of 1950: A Summary and Legislative History” *Social Security Bulletin*. October 1950.

⁴⁷ North, “Employment Tax Morass.”

more aggressively sought out and punished offenders. But to wrangle so many self-employed individuals would have been a difficult project. Easier, perhaps, to shift the compliance burden from individuals to corporations by reclassifying those workers as employees where possible. Independent salespeople—and direct sellers in particular—became a key target. If the IRS could prove that direct sellers had been misclassified, it stood to collect hundreds of millions in unpaid taxes, plus penalties and interest. According to one estimate, reclassification could have generated additional assessments of \$107 million per year.⁴⁸ *Queen's-Way* was the test case.

In 1977, an appeals court ruled in *Queen's-Way's* favor. The presiding judge declared, “there is not here the relation of employer-employee.” The *Queen's-Way* distributor “is too free; there is no itemized control by the alleged employer. There is an ultimate goal—the sale of the product on a commission basis—but the manner of attainment of that object, however, is totally left to the individual solicitor.”⁴⁹ Distributors, in other words, had too much autonomy in their daily work to meet the common law control test. The IRS contended during trial that *Queen's-Way* distributors could be terminated, and one must be employed to be fired. *Queen's-Way's* attorneys rebutted that “terminate” referred in this instance to the dissolution of a distributorship and the removal of a distributor’s name from the company’s mailing list rather than the termination of an employment contract. The relationship could be severed, moreover, by either the corporation or the distributor. At the conclusion of each transaction, attorneys argued, neither party had any assurance the relationship would continue.

The *Queen's-Way* application specifically stated it was not an employment contract:

The Counselor understands: (1) that she (or he) is an independent, self-employed person in business for himself and not an employee of QUEEN'S-WAY TO FASHION, INC.; (2) that she (or he) is not covered through the Company by the Unemployment or Workman's

⁴⁸ I.R.S. *News Release* No. IR-1868 at 4 (Aug. 6, 1977) (speech by Commissioner Kurtz before the ABA.) cited in North, “Employment Tax Morass,” 797.

⁴⁹ *Aparacor, Inc., Formerly Queen's-Way to Fashion, Inc. v. the United States*, 556 F.2d 1004, Federal Circuit 1977.

Compensation Act of any state; (3) that she (or he), of her (or his) own choosing, can be covered by the Federal Old Age and Survivors' Insurance benefits . . . by paying this tax direct to the Federal Government.⁵⁰

Numerous distributors testified they did not consider themselves employees of the firm but independent operators. Corporate management, they insisted, might suggest methods for marketing and selling merchandise, or for recruiting and training new sellers, but they were merely a “clearing house” for disseminating best practices solicited from sellers in the field.

Queen's-Way's attorneys pointed also to the IRS' own record of treating direct sellers as independent contractors. Direct sellers had for years filed self-employment taxes including Form 1040 Schedule C: “Profit (of loss) from business or profession,” Schedule E: “Computation of social security self-employment tax,” and Form 1120: U.S. Corporation Income Tax Return. If the IRS truly doubted the independent status of direct sellers, why did it not reject all those returns? Attorneys implied that the IRS was double-dipping. If Queen's-Way did pay back-taxes, plus penalties, the IRS would not automatically refund the self-employment taxes already paid by individuals. Each individual, whom the IRS was not obligated to inform, would have to file for a refund.

The judge's final ruling was based on the semi-attached structure of and autonomy in the relationship between Queen's-Way and its distributors, not the alleged intent of the IRS.⁵¹ Distributors did not, in the judge's estimation, satisfy the common law control test. Distributors worked solely on commission. They paid their own expenses. They received merchandise shipped C.O.D. from Queen's-Way for the full retail price. Upon selling the merchandise, the distributor

⁵⁰ Ibid.

⁵¹ I refer throughout the book to the direct sales model of labor as “semi-attached.” Direct sellers are not classified as employees but neither are they fully autonomous business people. Direct sellers operate under the banner of the firm and must abide by its corporate policies. They are attached to a firm though not employed by it; they are therefore “semi-attached.”

received an “override” commission rather than wage. In addition, distributors did not receive any other compensation or benefit typical in an employer-employee relationship such as paid vacation, sick leave, health insurance, or a pension. The court’s logic was in this way circular. Direct sales firms had since the 1930s used the independent contractor label to avoid providing sellers with a salary and benefits. Now, in the Queen’s-Way case, the absence of such benefits justified the firm’s claim that direct sellers were independent contractors.

The court also determined that distributors did not meet the economic reality test established in *United States v. Silk*.⁵² The risk of profit and loss fell primarily on the distributor. Distributors were not, to the court’s view, central to Queen’s-Way’s core business operations. The firm seemed to function more like “a supplier to . . . independent enterprises, each with its own clientele, and each capable of providing distribution services to a variety of products and other suppliers.” Direct sales firms thus represented a “radical departure from the traditional common law concept of an employer-employee relationship.”⁵³ This was a major victory for Queen’s-Way and for all direct sales firms. More than relieving one corporation from the burden of paying millions in back-taxes, *Queen’s-Way* set a clear legal precedent that reaffirmed the use of independent contractors, which had been at the heart of the direct sales strategy since the 1930s.

Queen’s-Way preserved not only direct sales labor practices but also the common-law understanding of the employer-employee relationship as one that was fundamentally about managerial control. Taken together, changes to Social Security requirements in the 1950s; legal disputes about the status of coal truckers, band musician, homebased garment workers and others; and the broadening of FUTA coverage in the 1970s demonstrate a persistent contest over the meaning of employment. The U.S. state was presented with many opportunities to adopt a new,

⁵² *United States v. Silk* 331 U.S. 704 (1947).

⁵³ *Aparacor, Inc. v. US*.

more capacious definition of employment that would encompass, and in some cases therefore protect, a greater number and range of workers, but repeatedly reinforced a narrower one. Rather than revise the definition of employment to better match the nature of work in the latter-half of the twentieth century, the state dismissed alternative modes of labor as “non-employment.”

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As in the case of *Amway*, leaders within the direct sales industry managed in *Queen’s-Way* to translate a legal challenge into a legal affirmation. Yet, the *Queen’s-Way* victory did not preclude similar trials in the future. Fearing the IRS would continue to litigate against other direct sales firms, or that a change to the tax code or legal classification of direct sellers would overturn *Queen’s-Way*, Neil Offen and members of the DSA determined they needed more than legal precedent; they needed protective legislation. In cooperation with executives from the real estate and construction industries, both of which relied on independent workers, the DSA began in the mid-1970s to lobby for some measure of legal protection to guard against future threats of reclassification.

After ten years of lobbying, the DSA succeeded in including in the Tax Equity and Fiscal Responsibility Act of 1982 the following clause:

Section E: Employment Taxes—Provides that real estate agents and direct sellers shall be considered nonemployees for purposes of employment taxes. Sets forth requirements for such classification. Sets forth procedures for determining an employer’s liability for employee taxes which are not withheld or reported.⁵⁴

Section E of the Tax Equity Bill, which was introduced by Leon Panetta and supported by Dick Gephardt and Bob Dole, functioned as a safe harbor clause for industries that met certain criteria to be protected by statute from future reclassification by the IRS.

⁵⁴ HR.R.4961 Tax Equity and Fiscal Responsibility Act of 1982, Conference Report No 97-530, 97th Congress, 1982. Publ.L. 970248. See also Sheppard, “Direct Sellers Hit.”

In addition to Section E, the resulting addition of Section 3508 of the Internal Revenue Code firmly defined direct sellers as “statutory non-employees,” or part of a category of work explicitly excluded from the definition of employment by statute. Section 3508 stated “the tax treatment of services performed as a qualified real estate agent or a direct seller . . . will not be treated as an employee, and the person for whom the services are proffered shall not be treated as an employer.”⁵⁵ Certain elder companions and home healthcare workers were later added to the list of the non-employed. Section 3508 also included specific criteria, which came from the *Queen’s-Way* decision as well as guidance from the DSA, to determine whether one qualified for the direct sales exemption. It defined an independent seller as one who sold consumer products on a buy-sell or deposit-commission basis, engaged in sales activities outside a brick-and-mortar retail establishment, was paid commission independent of the number of hours worked, and who operated according to a written contract that stated salespeople would not be treated as employees for Federal tax purposes.

Section 3508 boiled independent status down to three basic measures: the type of activity performed, the type of pay received, and the existence of a written contract that defined one as a “non-employee.” The safe harbor cause was a boon to the direct sales industry and in some ways also to the IRS. It provided clear, and importantly predictable, rules for auditors as well as firms. In addition to Section 3508, the IRS revised portions of the Internal Revenue Manual to provide more explicit guidelines for agents to conduct in-depth employment tax audits on independent contractors, and to improve compliance with the new rules. By the 1990s, the IRS training manual for Revenue Agents on workers-classification issues included a subchapter specific to statutory nonemployees, including direct sellers.⁵⁶

⁵⁵ Internal Revenue Code Section 3508(a).

⁵⁶ IRS, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (Oct. 1996), at 3-17 to 3-19, www.irs.gov/pub/irs-utl/emporind.pdf. cited in Sheppard, “Direct Sellers Hit.”

By 1990, the direct sales industry had survived legal challenges from the IRS, FTC, and Congress. Amway emerged from the FTC's investigation not merely intact but with the FTC's official endorsement as a legitimate networked sales organization. Offen and the DSA similarly leveraged the decision in *Queen's-Way* to obtain a legal precedent and legislation that created special tax exemption for direct sales firms. That protection, moreover, validated the industry's use of casual labor by translating the ad hoc definition of independent contractor that direct sales executives created in the 1930s into a legal category of work. If the FTC's efforts to regulate pyramid schemes in the 1970s provided the direct sales industry with a clear definition of a legal pyramid operation, the IRS' attempts to tax direct sales work similarly produced a firm definition of sellers' independent status as "statutory non-employment."

The DSA's efforts in the 1970s and early 1980s were reminiscent of those of the National Association of Direct Selling Companies in the 1930s, but key differences reveal much about the industry's evolution. The NADSC successfully obtained the independent contractor exemption for direct sellers because the industry was not among the National Recovery Administration's or the Senate and House Labor Committee's most pressing concerns. Relative to manufacturing, agriculture, or other sectors that might help stabilize the economy through regular employment, direct selling was in the 1930s neither large nor central enough to warrant debate about how best to categorize its workers. By the 1970s, however, direct sales was a significant sector of the consumer economy. With firms like Amway and Avon at the helm of a \$7 billion industry, direct sales firms wielded significant economic and political power as manufacturers and corporate citizens. Although they relied on independent sellers, firms such as Amway and Avon maintained corporate offices, manufacturing facilities, and distribution centers. They employed thousands of administrative and industrial workers. To challenge the basis of their low-cost sales strategy and thus threaten the financial health of a robust sector in the consumer and labor economies—particularly in the context

of unemployment, downsizing, and capital flight in the 1970s—was for politicians a losing proposition. Individual sales executives, most notably Jay Van Andel and Rich DeVos of Amway, also enjoyed significant political clout in the 1970s and would certainly have used it to push legislation favorable to their industry. In short, the NADSC succeeded in the 1930s because direct sales was too small to matter. The DSA in the 1970s, by contrast, succeeded because it was too big to ignore.