THE DELAWARE BANKRUPTCY

AMERICAN INN OF COURT

PONZI SCHEMES

Presented by February Pupilage Team:

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EXHIBIT 1

CHARLES PONZI AND THE ORIGIN OF THE "PONZI SCHEME"

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Charles Ponzi at work, 1920
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Despite the ancient adage, "You can't get something for nothing," many have tried to do just that by advancing "get rich quick" schemes. Many more have fallen for such schemes. From the days of the medieval alchemists, who sought to turn base metals into gold by use of a mysterious "philosopher's stone," unscrupulous individuals have sought to profit from credulous subjects whose desire for gain was untempered by reason.[1] The scheme which has

1 For further information, see Lawrence M. Principe and William R. Newman, *Some Problems With the Historiography of Alchemy*, in William R. Newton and Anthony Grafton, Secrets of Nature, Astrology and Alchemy in Modern Europe (2001). Note, however, that while there were some scurrilous individuals involved, the majority of alchemists were legitimate proto-scientists whose discoveries laid the foundation for modern chemistry.

come to be known as a "Ponzi Scheme," "an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors,"[2] and which is characterized by insolvency at the outset, has a long and venerable pedigree.

Charles Dickens, in one of his early works, *Martin Chuzzlewit* (1844), chronicled the nefarious actions of Montague Tigg, who established an organization known as *The Anglo-Bengalee Disinterested Loan and Life Assurance Company*, which operated what essentially became known as a pyramid scheme, a close cousin to the Ponzi Scheme.[3] In the pyramid scheme, investors "buy in" to the plan and are required to recruit further investors, who pay them, and so forth. Like the Ponzi Scheme, a pyramid scheme depends on an ever-growing number of contributions. Unlike the Ponzi Scheme, however, in the pyramid scheme the source of profit (further contributions) is not hidden, and individuals are openly reimbursed by the contributions of others, rather than from those higher-up in the chain of beneficiaries. The fraud here is that, to succeed in perpetuity, the required number of new investors must reach astronomical numbers which can never be achieved. Credulous investors who buy-in late in the scheme cannot recoup their contributions and are thus left "holding the bag" while the initiators skip town with the proceeds.

A half-century later, and an ocean away, one of the earliest examples of a Ponzi Scheme was begun. In March 1899, William Miller, a 25-year-old Sunday School teacher, opened the "Franklin Syndicate" in Brooklyn, New York. He solicited investments from friends and eventually the public, promising 10% per week interest on the money, which he planned to

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2 Securities and Exchange Commission, "Ponzi Schemes – Frequently Asked Questions," http://www.sec.gov/answers/ponzi.htm. Viewed 7 February 2013.

3 CHARLES DICKENS, MARTIN CHUZZLEWIT (1844), available online at http://www.gutenberg.org/ebooks/968.

invest in the stock market. He advertised widely, explaining that his success was due to methods that, although in keeping with the oligarchic craze of the 1890s, today would be entirely illegal:

> My intention is to make the Franklin Syndicate one of the largest and strongest syndicates operating in Wall Street, which will enable us to manipulate stocks, putting them up or down as we desire. We also guarantee you against loss, there being absolutely no risk of losing, as we depend entirely on inside information.[4]

On hearing reports of Miller's success, the *Wall Street Journal* praised him as "a New Wizard in the Realms of Stock Manipulation." After Miller lost the first thousand dollars he invested, however, he determined to make good on his promises by taking money from later investors to pay back earlier investors, and encouraging his investors to reinvest, rather than withdraw, the proceeds. For a time this approach was so successful that he became known as "520% Miller" and raked in $1 million in a matter of months. "So great was the crush," one newspaper reported, "that the stoop of the house [where he set up shop] was broken by the people anxious to invest their money with Miller."[5] Indeed, Miller allegedly had to build special vaults under his house to contain all of the money and hired a workforce of 50 clerks to handle the crowds seeking to invest. By November, however, Miller's artifice was discovered. Although he fled to Canada, he was soon located and brought back to New York for trial. He was convicted and sentenced to ten years in prison.[6] However, two of Miller's associates absconded with large portions of the funds and were never heard from again. They demonstrate

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4 Mark Gribben, *The Franklin Syndicate*, THE MALEFACTOR'S REGISTER, http://malefactorsregister.com/wp/?p=70 (last visited Feb. 11, 2013).

5 *William F. Miller Arrested*, N.Y. TIMES, Nov. 22, 1899.

6 *Top Ten Swindlers: William Miller, the Original Schemer*, TIME, http://www.time.com/time/specials/packages/article/0,28804,2104982_2104983_2104992,00.html (last visited Feb. 11, 2013).

the motivation for any would-be Ponzi schemer given the inevitable collapse of the scheme itself.[7]

Enter Charles Ponzi. Born Carlo Pietro Giovanni Guglielmo Tebaldo Ponzi in Lugo, not far from Bologna in northern Italy, on March 3, 1882, he boarded the ship *S.S. Vancouver*, which sailed from Naples on November 3, 1903, and arrived in Boston on November 17th. The ship manifest records him as "Mr. Carlo Ponsil, age 21, a student, literate, a southern Italian, whose last residence was Rome, whose destination was Pittsburgh, Pa. to his cousin, Ludovico Seepogle.[8] "I landed in this country with $2.50 in cash[9] and $1 million in hopes," he later remarked, "and those hopes never left me."[10] At first he found a position as a waiter but, in an early indication of his lack of scruple about taking advantage of any situation he encountered, he was fired for cheating his customers.

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7 The question of why someone would engage in this kind of scheme given its inevitable discovery is an interesting one. One supposes that the Ponzi scheme artists could be divided into three camps. The first, like Miller's associates Col. Robert Ammon and Edward Schlessinger, knew that the collapse was coming and made plans to abscond with the proceeds to places where they were could not be reached. Others perhaps kidded themselves with the thought that the discovery would not be made in their lifetime – like Louis XV of France, who, when contemplating the degradation of his empire, dismissively remarked, "Après moi, le déluge!" (After me, the flood!). The third camp, like Ponzi's boss, apparently fall into the scheme as a means to cover previous losses. When asked why he did it for so long, Bernie Madoff replied, "I thought I could do it. I did! I took the money . . . and I was convinced that when the market straightened out I would be able to cover things." David Gelles and Gillian Tett, *From Behind Bars, Madoff Spins His Story*, FINANCIAL TIMES (Apr. 8, 2011), http://www.ft.com/intl/cms/s/2/a29d2b4a-60b7-11e0-a182-00144feab49a.html#axzz2KdsYHTXM.

8 Passenger Manifest of S.S. Vancouver, archived at www.ancestry.com.

9 The ship manifest, *supra*, indicates that he was in possession of $25.00 at the time of his arrival.

10 Mary Darby, *In Ponzi We Trust*, SMITHSONIAN MAGAZINE, Dec. 1998, http://www.smithsonianmag.com/people-places/In-Ponzi-We-Trust.html.

In 1907 Ponzi moved to Montreal and became a bank teller and later a bank manager. The bank in which he worked had promised more than it could deliver in terms of investment returns, and Ponzi's superior had taken to siphoning money from earlier deposits to pay withdrawals at the promised rate of interest. It seems very likely that Ponzi's observation of this behavior planted the seeds for his later scheme.

After spending time in Canadian prison for forging a check, Ponzi returned to the United States, where he was arrested and convicted of smuggling illegal Italian immigrants into the United States from Canada.[11] Eventually, he returned to Boston where he married Rose Maria Gnecco, the daughter of a grocer. Ponzi assumed the management of his father-in-law's business but ran it into the ground.[12] By 1919, he had decided anew to make his fortune, this time by selling advertising directories as a clerk for J. R. Poole, Merchandiser. This plan also failed, but in the meantime Ponzi received an inquiry concerning the directories from a business in Spain. Enclosed in the inquiry was an international reply coupon (IRC).[13] Introduced in 1906, IRCs were slowly gaining popularity among the immigrants who were flocking to the United States in droves. These coupons, issued in every member country of the Universal Postal Union, were redeemable at a post office for a single-rate, ordinary postage stamp for delivery to a foreign country. They were invented to facilitate the equivalent of a "self-addressed stamped envelope" across international lines, and were designed to be sent as a courtesy with international correspondence to enable the recipient to send a reply at no cost to him or herself.

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11 *Charles Ponzi's Atlanta Connection*, ATLANTA DAYBOOK, https://atlanta.daybooknetwork.com/story/2009-03-23/18408-ponzi-in-atlanta-release/ (last visited Feb. 12, 2013).

12 Darby, *supra* note 10.

13 *The Great Swindler*, SMITHSONIAN NATIONAL POSTAL MUSEUM, http://www.postalmuseum.si.edu/inspectors/a3p2.html (last visited Feb. 12, 2013).

A recipient need only take an IRC to his or her local post office and redeem it for the amount of postage required to mail a letter to the desired country.[14]

Ponzi realized almost immediately that there was a tremendous opportunity for arbitrage in this system. Because the cost of postage for an equivalent letter varied from country to country based upon currency differences and other considerations, Ponzi recognized that he could profit enormously by purchasing an IRC in one country and redeeming it for postage in another country where the value of the equivalent amount of postage was greater. Consequently, Ponzi set up a business called the "Securities Exchange Company." He contacted his relatives in Italy and asked them to buy up as many IRCs as possible and send them to him.

It appears, however, that Ponzi, whom an associate later called a "financial idiot," and whose only business records were index cards containing the names of his clients, belatedly discovered that the costs of acquiring a package of IRCs from abroad apparently exceeded the difference that could be gained on arbitrage. Undaunted, Ponzi fell back on the trick he had learned from his former boss in Canada – paying off the original investors by using proceeds from more recent investments. What happened next is well summarized by the Supreme Court:

> He spread the false tale that on his own account he was engaged in buying international postal coupons in foreign countries and selling them in other countries at 100 per cent. profit, and that this was made possible by the excessive differences in the rates of exchange following the war. He was willing, he said, to give others the opportunity to share with him this profit. By a written promise in 90 days to pay them $150 for every $100 loaned, he induced thousands to lend him. He stimulated their avidity by paying his 90-day notes in full at the end of 45 days, and by circulating the notice that he would pay any unmatured note presented in less than 45 days at 100 per cent. of the loan. Within eight months he took in $9,582,000, for which he issued his notes for $14,374,000. He paid his agents a commission of 10 per cent. With the 50 per cent. promised to lenders, every loan paid in full with the profit would cost him 60 per cent. He was always insolvent, and became daily more so, the more his business

14 *See id.*

succeeded. He made no investments of any kind, so that all the money he had at any time was solely the result of loans by his dupes. By July 1st, Ponzi was taking in about $1,000,000 a week.[15]

Ponzi described a typical daily scene:

> A huge line of investors, four abreast, stretched from the City Hall Annex, through City Hall Avenue and School Street, to the entrance of the Niles Building, up stairways, along the corridors...all the way to my office! . . . Hope and greed could be read in everybody's countenance. Guessed from the wads of money nervously clutched and waved by thousands of outstretched fists! Madness, money madness, the worst kind of madness, was reflected in everybody's eyes! . . . To the crowd there assembled, I was the realization of their dreams....The 'wizard' who could turn a pauper into a millionaire overnight![16]

He used his profits to live large, moving into a mansion with servants and acquiring a controlling interest in a local bank, the Hanover Trust Company, in which the State of Massachusetts had considerable funds deposited. Eventually, however, his astounding rates of return came under scrutiny. Financial analyst Clarence Barron discovered that Ponzi was not investing any of his own money into the enterprise, which raised red flags. Barron also calculated that, to generate the arbitrage results Ponzi was claiming, over 160 million postal reply coupons would have to have been purchased, but only 27,000 were then in circulation worldwide.[17] The court noted that

> Because of an investigation by public authority, Ponzi ceased selling notes on July 26th, but offered and continued to pay all unmatured notes for the amount originally paid in, and all matured notes which had run 45 days, in full. The report of the investigation caused a run on Ponzi's Boston office by investors seeking payment.

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15 *Cunningham v. Brown*, 265 U.S. 1, 8-9 (1924) (Taft, C.J.).

16 Darby, *supra* note 10.

17 *See Prizes for Best Journalistic Work*, THE FOURTH ESTATE, June 14, 1921, at 13.

Ponzi, an unparalleled charmer, was initially able to quell the resulting panic by paying out millions and appearing among the frenzied public, handing out coffee and donuts and making grandiose reassurances as he "gave his thin bamboo cane a dandified switch and touched the tip of one of his two-toned shoes." An associate later recalled that "[w]hen he was cornered, he used the old technique that such a question could not be answered as it would disclose his financial secrets to the big bankers of Wall Street and Threadneedle Street and the Paris Bourse. Once, Attorney General Allen said to him, 'Mr. Ponzi, if you can do these things that you claim, you will be the greatest Italian who ever came to America.' To this, Ponzi smiled and said, 'Don't forget Columbus, Mr. Allen!'"[18] To ward off further danger, Ponzi decided to hire a publicity agent. This proved to be the cause of his downfall, for he hired the notoriously honest William McMasters. After just ten days on the job, however, McMasters, discovered the truth of the scheme. As McMasters would later recall,

> [I realized that] the only money he had in his hands as of right now was money taken from investors. . . .The huge profits that he discussed so glibly were mythical and nonexistent. . . . Once I had reached that conclusion, I knew that I was faced with a duty that I owed to the public if I expected to stay in business for the rest of my life.

McMasters went straight to the *Boston Post* and arranged to have a story published, after carefully wording his allegations to avoid accusations of libel. Once the news broke on August 2,[19] furious investors again demanded their money back. As the court noted,

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18 Cora Bullock, *The Man Who Time (Almost) Forgot: William H. McMasters Finally Gets His Due For Exposing Ponzi*, FRAUD MAGAZINE, http://www.fraud-magazine.com/article.aspx?id=4294970026 (last visited Feb. 12, 2013). See also *'Postage Stamp King' Defies Federal Government to Learn How He Profits*, WASHINGTON POST, July 30, 1920 ("My secret is how to cash the coupons. I do not tell it to anyone. . . . Let the United States find it out, if it can.").

19 *Declares Ponzi Is Now Hopelessly Insolvent*, THE BOSTON POST, Aug. 2, 1920.

> To meet this emergency, Ponzi concentrated all his available money from other banks in Boston and New England in the Hanover Trust Company [as he attempted to make payments]. . . . It was finally ended by an overdraft on August 9th of $331,000. The petition in bankruptcy was then filed.[20]

Ponzi surrendered to authorities on August 12, 1920. On October 25, 1920, he was adjudged a bankrupt in the United States District Court for the District of Massachusetts.[21] This, however, was the least of his worries, as Ponzi was charged with numerous criminal offenses, both state and federal. He pleaded guilty to one count of mail fraud and was sentenced to five years in federal prison, of which he served three and a half years. While still a federal prisoner he was subjected to trial on state charges of larceny. Ponzi argued that he could not be tried while still serving his federal sentence, but the Supreme Court stated otherwise in *Ponzi v. Fessenden*, 258 U.S. 254 (1922). After three attempts at trial in state court, Ponzi was found guilty and sentenced to seven to nine years' imprisonment.

Astoundingly, Ponzi was released on bail pending appeal and promptly escaped to Florida under the name "Charpon." There, during 1926, he briefly became involved in a venture selling underwater swampland to investors with a promise of 200% returns in 60 days. He was arrested, charged and found guilty of violating Florida Trust and Securities Laws, but again posted bond pending appeal and escaped.[22] Disguised, he boarded a ship bound for Italy, but was recognized when the ship docked temporarily in New Orleans. He was returned to Massachusetts and served seven years of his state prison term there. Upon his release in 1934,

20 The opinion deals with whether certain individuals who had received payouts from the fund in the days prior to its collapse were the recipients of preferences under the Bankruptcy Act. The Court concluded that they were.

21 *Ponzi Adjudged Bankrupt*. N.Y. TIMES, Oct. 26, 1920.

22 Darby, *supra* note 10.

he was deported to Italy.[23] His wife, desiring to remain in America, divorced him.[24] After a brief sojourn in Italy, he made his way to Brazil where he worked for an airline and later as a translator. His health failed him, and he died in a charity hospital Rio de Janeiro on January 18, 1949, with only $75 to pay for his funeral.[25]

Near the end of his life, almost blind and suffering from heart failure, Ponzi said,

> Even if they never got anything for it, it was cheap at that price. Without malice aforethought I had given them the best show that was ever staged in their territory since the landing of the Pilgrims! It was easily worth fifteen million bucks to watch me put the thing over.[26]

The classic "Ponzi Scheme" thus involves the use of later investors' money to pay back earlier investors' returns. The investments – and "returns" – are thus all funneled through one individual or entity. It thus differs from the pyramid scheme, in which investors are explicitly promised returns through their efforts to recruit later investors, because in the pyramid scheme the apparatus (later investors paying back earlier investors) is made apparent, but it is

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23 *Ponzi Must Leave Tonight*, N.Y. TIMES, July 10, 1934. Records of the District Court for the District of Massachusetts show that although Charles Ponzi declared his intention to become a United States citizen on March 28, 1918, and filed his petition for naturalization on March 28, 1925 (at that time listing his occupation as "clerk"), soon thereafter he filed a motion with the Court noting that "Being advised that my petition for naturalization . . . does not conform to the Naturalization Statutes in that it is not properly verified by the attesting witnesses, I move that it be dismissed without prejudice." His petition for naturalization was accordingly dismissed on June 8, 1925, and apparently was never refiled.

24 It was a peculiar feature of the naturalization laws between 1907 and 1922 (and during some other intervals) that, while a foreign woman who married a U.S. citizen instantly became a U.S. citizen, an American-born woman who married a foreigner lost her citizenship upon marriage. Marian L. Smith, *'Any Woman Who Is Now or May Hereafter Be Married . . .' Women and Naturalization, ca. 1802-1940*, PROLOGUE, Sept. 1998.

25 Darby, *supra* note 10.

26 *Id.*

assumed or projected that the number of investors can double indefinitely. In the Ponzi Scheme, the entire idea that earlier investors are compensated from the payments of later investors is obscured behind some type of commercial façade.

Before one judges Ponzi's contemporaries and wonders how he could have possibly gotten away with his crime for so long in the face of so many newspaper interviews, one must understand that Ponzi was able to put on a cunning charade and benefited from the limited technology of his day which hindered his contemporaries from ascertaining his true background. Although technology is far more advanced today, there are those who, in the face of overwhelming odds, can skirt its limitations and persevere in telling the people what they want to hear. The ability to project such confidence that it dispels any rational doubts is the true mark of the Ponzi schemer. As is well known, in the United States, Bernard Madoff's firm, Bernard L. Madoff Investment Securities LLC, committed the largest financial fraud in U.S. history, involving some $36 billion, and returning investors' funds with payments made by other investors. Dozens of other, smaller schemes have arisen over the years, both in the United States and abroad. As the New York Times remarked soon after Ponzi's arrest,

> [T]here is an element of misconduct on the part of those who allow themselves to be partners in such duplicity. . . . The losses of [Ponzi's] dupes excuse them only in proportion that his excuse him. . . . We know what to think of people who buy goods so cheap as to show that there is something crooked about the price.[27]

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27 Editorial, *The Ponzi Lesson*, N.Y. TIMES, August 14, 1920.

EXHIBIT 2

THE COMMON PONZI SCHEME

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COUSINS CHIPMAN & BROWN, LLP

A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. There are five key elements of a Ponzi scheme:

1. **The Benefit:** In a Ponzi scheme, potential investors are wooed with promises of unusually large and consistent returns with little or no risk, usually attributed to the investment manager's savvy or skill.

2. **The Setup:** The promises are accompanied by a relatively plausible explanation of how the investment can achieve these above normal rates of return. This is usually attributed to the investment manager's savvy, skill, and/or inside information. Another commonly used explanation is that the investor has knowledge of an opportunity not otherwise available to the general public.

3. **Initial Credibility:** The person running the scheme needs to be believable enough to convince the initial investors to leave their money in his care.

4. **Initial Investors Are Paid Off:** For at least a few periods, the investors need to make at least the promised rate of return, if not better.

5. **Communicated Successes:** Other investors need to hear about the payoffs, such that their numbers grow exponentially. At the very least more money needs to be coming in than is being paid back to investors.

Ponzi schemes are basic but can be extraordinarily powerful. The basic layout of a Ponzi scheme includes four steps:

1. Convince a few investors to place money into the investment.

2. After the specified time, return the investment money to the investors, plus the specified interest rate or return.

3. Pointing to the historical success of the investment, convince more investors to place their money into the system. Typically the vast majority of the earlier investors will reinvest.

4. Repeat the above steps a number of times. During step 2 at one of the cycles, the perpetrator of the scheme will break the pattern. Instead of returning the investment money and paying the promised return, he either escapes with the money or the authorities apprehend him.

The SEC investigates and prosecutes many Ponzi scheme cases each year both to prevent new victims from being harmed and to maximize the recovery of assets to investors. The majority of such cases are brought as emergency actions, which often seek a temporary restraining order and an asset freeze. Ponzi scheme "red flags" include:

- High investments returns with little or no risk;
- Overly consistent returns;
- Unregistered investments;
- Unlicensed sellers' secretive and/or complex strategies;
- Issues with paperwork; or
- Difficulty receiving payments.

Perpetuation of the high returns requires an ever-increasing flow of money from new investors to keep the scheme going. Therefore, the scheme has the possibility to continue as long as new investors line up with cash, and old investors do not try to withdraw too much of their money at once. The system is thus destined to collapse, however, because the earnings, if any, are less than the payments to investors, and investors and legal authorities are bound to become suspicious.

The $65 billion fraud that Bernard L. Madoff perpetrated has been called the largest Ponzi scheme in history. Madoff is currently serving a 150-year sentence in federal prison for his Ponzi scheme that swindled money from thousands of investors for years.

EXHIBIT 3

Commercial Fraud Task Force Committee

The ABI Commercial Fraud Task Force Committee facilitates information sharing, training, and education between ABI members and the public-private sector to combat commercial bankruptcy fraud.

Ponzi Schemes in Bankruptcy

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Ponzi schemes are named after confidence man Charles Ponzi, who invented a scheme to profit from foreign exchange arbitrage through the purchase and redemption of postal coupons after World War I. Ponzi attracted financial backing for his scheme by offering investors enormous returns. As he paid early investors the high returns they were promised, word spread and Ponzi began collecting cash from investors at a frenzied pace. However the postal coupon scheme did not generate enough profit to pay the returns Ponzi promised, and in fact he went deeper into debt with each transaction. He was only able to sustain the scheme by paying returns to earlier investors with cash received from later investors. When authorities began to investigate Ponzi's business, investors became spooked, new investment funds dried up and the scheme quickly collapsed, leaving Ponzi unable to repay any of the remaining investors.

The purpose of this article is to explore the characteristics of Ponzi schemes, the significance of Ponzi schemes in bankruptcy cases and the evidence required to prove the existence of a Ponzi scheme. Not all failed businesses are the result of illegitimate activity. However, if a failed business is a Ponzi scheme, the likelihood of a successful recovery action in bankruptcy is vastly improved. Over the past three years, we have had the opportunity to investigate several Ponzi schemes. In each instance we were asked to establish both that the debtor was indeed operating a Ponzi scheme, and the first date upon which the debtor's operations became a Ponzi scheme. This can be easy to do in instances where the debtor's operation is launched as a criminal Ponzi enterprise from the beginning. It is more difficult, however, when the debtor initially operates a legitimate business but for reasons of financial hardship, the business gradually morphs into a criminal enterprise. The bankruptcy trustee, once appointed, quickly encounters two things; a large body of jilted unsecured creditors clamoring for their money back, and few, if any, existing assets with which to pay them. If the jilted creditors are to be paid, the source of payment will almost always be the lucky investors who actually made money in the scheme. That is, the trustee must sue the "winners" to pay the "losers."

The remedies available to a trustee for this purpose are uniquely powerful ones. But they arise only if the trustee can show, as a threshold matter, that the debtor was in fact an operating Ponzi scheme. Whether the debtor was doing so is thus a singularly important issue. A brief description of some of the remedies available to a trustee who succeeds in carrying this initial burden will suffice to show just how important the issue is.

First, any distribution to an "investor" above the investor's initial undertaking (*i.e.*, any distribution in excess of principal) constitutes a fraudulent transfer as a matter of law. All interest or other "Ponzi Profit" payments to investors are therefore at risk, regardless of the relative guilt or innocence of the individual investors.

Second, the debtor in a Ponzi scheme case is presumed to have acted with fraudulent intent. Thus, any and all payments by the debtor to investors, even refunds of invested principal, are recoverable by the trustee unless the defendant can prove both (1) good faith and (2) an exchange of reasonable equivalent value. The burden is on the investor, not on the trustee, to do this. Since Ponzi schemes often involve unorthodox transactions (for example, post-dated checks), good faith is typically difficult, if not impossible, for the investor to establish. Thus, even the investor's principal is at risk.

Third, with respect to preferential transfers, the cases generally hold that there is no ordinary course of business defense in a Ponzi scheme case, there being "nothing ordinary" about a Ponzi operation. Since Ponzi operators tend to pay the greatest number of payments–and the highest payment amounts–immediately before the operation collapses (which often corresponds more or less to the 90-day preference period), a great proportion of the dollars distributed be the Ponzi operator are recoverable as preferences.

Of course the underlying dynamic driving any Ponzi scheme is greed. Investors suspend good judgment and overlook basic due diligence in their eagerness to get in on the action. In the Ponzi schemes we investigated, investors received profits for short-term investments and did not bother to annualize their returns. Consequently, investors were desensitized to the ridiculousness of their yields. A 6 percent return over 45 days looks like 6 percent, not the approximate 50 percent annualized return.

The key to a good Ponzi scheme is to make sure early investors get their money back since the best way to prolong a Ponzi scheme is through repeat investors. Effective operators overcome skepticism by having cash available to retire a nervous investor's obligation. An investor who promptly receives his money back is often embarrassed for having doubted the business acumen of the operator, and may overcome this humility by investing more heavily, and telling his friends about the great opportunity. The aftermath of a Ponzi scheme is a little like the remains of a nuclear explosion. After the mushroom cloud dissipates few, if any, assets exist. The short-term winners in a Ponzi scheme are the investors that get out before the scheme blows up and the promoters who raise investors' funds for a piece of the action or a commission but put none of their own capital at risk.

The key for a trustee, then, as indicated, is to establish that the debtor's operation was indeed a Ponzi scheme. The purpose of this article is to address this issue. What proof will suffice to establish this critical point?

This is relatively easy to prove in instances where the debtor's operation is launched as a "pure" Ponzi enterprise from the beginning. This point was well explained in *Merrill v Abbott (In re Independent Clearing House Co.)*, 77 Bankr. 843 (D.C. Utah, 1987):

> The evidence before the Bankruptcy Court ... showed that the Debtors conducted no business operations, never generated any profits or earnings, paid all monthly disbursements to [investors] solely from [investors'] investments, were insolvent from the moment the first investment contract was executed, became more insolvent with each successive contract, and ran their business as a Ponzi scheme ... Thus, it was undisputed that the Debtors' business was "conducted as a Ponzi scheme...." 77 Bankr. at 859.

The court held that a transfer need not be made with intent to hinder, delay or defraud a specific transferee to constitute "international fraud." Rather, "the trustee need only show that the transfers were made with the intent to hinder, delay or defraud an entity to which the debtor was *or became* indebted on or *after the date that such transfer occurred*." 77 Bankr. 860 (emphasis in original).

Since Ponzi schemes must, as a matter of scientific necessity, eventually collapse and leave some creditors unpaid, one can therefore always infer the necessary intent:

> Indeed no other reasonable inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which, by definition, are meant to attract new investors. He must know all along, from the very nature of his activities, that the investors at the end of the line will lose their money. Knowledge to a substantial certainty constitutes intent within the eyes of the law.
> 77 Bankr. at 860.

Ponzi schemes generally have the following characteristics:

(1) *Capital Providers.* A Ponzi scheme thrives on funds provided by third-party investors. These could be individuals or financial institutions providing cash in the form of either debt or equity. Generally, the distinction between "debt" and "equity" is of little importance because any infusion of capital gives rise to an equitable obligation by the debtor to return it. The

return of funds by the debtor to the investor is therefore arguably the satisfaction of a debt, either expressed or implied. Distinction between debt or equity capital is also unnecessary since the profitable business activity required to service both forms of capital is absent in a Ponzi scheme.

(2) *Existence of Fraud.* Ponzi operators invariably make false representations to their "investors," and do so knowingly. That is, the Ponzi operator will pitch the business as if it were legitimate, while knowing that new loan proceeds will be used to repay earlier lenders, not to invest in the enterprise "pitched" to the investor. Often, the only business being conducted is the raising of investor funds. Intent is often difficult to prove directly. This requires a careful cataloging of the number of investors, the amount and timing of their investments, the legitimate profits (if any) generated from the debtor's business activities, and the tracing of payments from payment sources. Proving that the debtor knew some existing or future creditor would go unpaid is much more difficult, however, when the debtor initially operates a legitimate business, encounters financial hardship and reacts not by closing or changing the business, but by borrowing money to keep the business afloat. If the debtor does so knowing or suspecting that the business is not healthy enough to retire new debt when it comes due, but represents otherwise to the new lender, he has engaged in the same basic deception that "pure" Ponzi operators use from the beginning. If, when the new debt comes due, the debtor pays it with a yet another new loan, and does the same thing again when the new loan matures, he has become as much a Ponzi operator as Charles Ponzi himself. This evidence generally is sufficient to enable the trier of fact to infer that the Ponzi operator formed the requisite criminal intent.

(3) *High Rates of Return.* A Ponzi operator's pitch to investors will typically not withstand even the most perfunctory due diligence by the investor. The key for the Ponzi operator is therefore to get people to invest without asking too many questions. To accomplish this, the Ponzi operator will typically do two things. First, offer extremely high rates of return. And second, actually pay such returns to earlier investors. This creates a level of temptation (the so-called "greed factor") that is exploited to assure a steady stream of new investors. A Ponzi operation will therefore usually involve extremely high rates of return over short periods of time and at least an initial pool of lucky investors who actually rake in these high returns. The payment of extremely high returns to nontraditional lenders is particularly probative. It shows that the debtor knows, or at least suspects, that he would not qualify for bank financing. A willingness to overpay for credit shows desperation for new loan funds. We have investigated Ponzi schemes where rates of return ranged as high as 2,500% per annum. No business can sustain even anything close to that cost of capital. Any debtor who would agree to pay it can be presumed to understand that there is no hope of long term survival.

(4) *Increasing Insolvency.* A Ponzi scheme, by its very nature, becomes increasingly insolvent with each business transaction. It does so by the very "Ponzi" nature of the operation, which involves at its core the payment of previous loan obligations with the proceeds of later ones. The Ponzi scheme's ability to repay debts is solely contingent on raising new funds, which has the effect of deepening the insolvency. Since both past and current obligations entail carrying costs (primarily interest), the enterprise takes on more water with each transaction. If this "increasing insolvency" can be established, the debtor's intent to "hinder delay or defraud" its creditors is presumed. The most difficult part of a fraud case–proving that the debtor acted with the requisite intent–is therefore presumptively established. The importance of this to the trustee's

collection efforts cannot be over emphasized. The touchstone for all Ponzi operations is the concept of "increasing insolvency." The trustee must show that, with each new loan transaction, the debtor became more insolvent. To show this, the trustee might create a chart that plots the debtor's cash receipts and its gross recurring obligations. When each new loan is incorporated into the chart, it will often cause a wider and wider separation between income and expenses. If that separation continues to increase, and the trustee can show that the business is not able through operations to narrow the gap, the first and most basic element of a Ponzi scheme will have been established.

Not all hopeless businesses, however, are criminal enterprises. The trustee must also show knowledge on the debtor's part that the business was becoming increasingly insolvent and that the business could not sustain the new debt it incurred or was likely to incur in the future. That is, intent will be presumed only if the trustee can establish knowledge on the debtor's part that its increasing insolvency was irreversible, or that its debt could not be retired from cash generated by operations.

Possibly the best way to show this is by tracing new loan proceeds to the retirement of pre-existing debt (that is, robbing from Peter to pay Paul), rather than using the funds to invest in capital and equipment. If the debtor seeks new loans at the time pre-existing debt matures, uses the new loan proceeds to pay old debt and becomes increasingly insolvent in the process of doing so, the trier of fact can infer the requisite knowledge and intent. The facts, taken together, reveal (1) knowledge on the debtor's part that its operations are not self-sustaining, and (2) a plan by the debtor to stay afloat with borrowed funds. While such a debtor can, unlike a "pure" Ponzi operator, fall back on the "hope springs eternal" defense, a strong and well organized set of proofs by the trustee will often overwhelm this defense.

The key to establishing the existence of a Ponzi scheme is to demonstrate that the only source of repayment to investors is funds from other investors. Since no business activity exists, an analysis of the cash transferred in and out of the entity should be sufficient to show the sources and uses of funds. If there is business activity, it is important to understand the level of such activity and document the volume and the inadequate profitability available to service the debt load. There are trailing pieces of evidence that can support your conclusions on the scheme such as computing and documenting the costs of capital and comparing it to the profit margins of any business activity. Such analysis highlights the ridiculousness of the proposition since Ponzi scheme businesses cannot sustain the level of profitability required to service the costs of invested capital. Rarely in Ponzi schemes is money invested in machinery, equipment, goods, services or even in alternative investment vehicles like stocks and bonds. Typically, the only disbursement activity in the checking account relates to payments to capital providers in the forms of interest or principal reductions on maturing obligations. Capital provider A's money is distributed to capital provider B. The cash coming into the entity is from capital providers, not customers.

Other evidence that might bear on this issue includes:

(a) Material misrepresentations by the debtor to lenders about income, expenses, and prospects.

EXHIBIT 4

IN THE MATTER OF

AMWAY CORPORATION, INC., ET AL.

FINAL ORDER, OPINION, ETC., IN REGARD TO ALLEGED VIOLATION OF THE FEDERAL TRADE COMMISSION ACT

Docket 9023. Complaint, March 25, 1975 — Final Order, May 8, 1979

This order, among other things, requires two Michigan corporations engaged in the door-to-door marketing of various household products, and two corporate officers, to cease allocating customers among their distributors; fixing wholesale and retail prices for their products; taking retaliatory action against recalcitrants; and disseminating price-listing data which fail to advise that price adherence is not obligatory. Respondents are additionally prohibited from misrepresenting potential earnings and other relevants to prospective distributors.

Appearances

For the Commission: *Joseph S. Brownman, D. Stuart Cameron, Mary Lou Steptoe, B. Milele Archibald* and *Michael Goldenberg.*

For the respondents: *Lee Loevinger, Philip C. Larson* and *Robert J. Kenney, Jr., Hogan & Hartson,* Washington, D.C. and *John E. Stephen,* Ada, Mich.

COMPLAINT

Pursuant to the provisions of the Federal Trade Commission Act (15 U.S.C. 41, *et seq.*) and by virtue of the authority vested in it by said Act, the Federal Trade Commission having reason to believe that the parties listed in the caption hereof and more particularly described and referred to hereinafter as respondents, have violated the provisions of Section 5 of the Federal Trade Commission Act, and it appearing to the Commission that a proceeding by it in respect thereof would be in the interest of the public, hereby issues its complaint, stating its charges as follows:

PARAGRAPH 1. Respondent Amway Corporation, Inc. is a corporation organized on or about September 6, 1949, under the name Ja-Ri Corporation, Inc. Its name was formally changed to Amway Corporation in November 1963. On or about January 1, 1964, Amway Sales Corporation, Amway Services Corporation and Amway Manufacturing Corporation, all of which were Michigan corporations, were merged into Amway Corporation, Inc. Respondent corporation maintains its home office and principal place of business at 7575 East Fulton Rd., Ada, Michigan. [2]

PAR. 2. Respondent Amway Distributors Association of the United

States is an association of Amway distributors and dealers, which maintains its home office and principal place of business at 7575 East Fulton Rd., Ada, Michigan. Among the functions and duties of the Amway Distributors Association are to make recommendations to respondent corporation with respect to the standing, termination or suspension of individual distributors or dealers, and to recommend changes or other action on various restrictions upon distributors or dealers.

PAR. 3. Respondent Jay Van Andel is Chairman of the Board of Directors of respondent corporation, and was one of its founders. Together with others, respondent Van Andel instituted the Amway marketing plan and distribution policies, and has been and continues to be responsible for establishing, supervising, directing and controlling the business activities and practices of corporate respondent. Mr. Van Andel's office address is the same as that of respondent corporation.

PAR. 4. Respondent Richard M. DeVos is President of respondent corporation, and was one of its founders. Together with others, respondent DeVos instituted the Amway marketing plan and distribution policies, and has been and continues to be responsible for establishing, supervising, directing and controlling the business activities and practices of corporate respondent. Mr. DeVos' office address is the same as that of respondent corporation.

PAR. 5. Respondent corporation is engaged in the manufacture, distribution, offering for sale and sale of more than 150 kinds of home-care, car-care and personal-care products, as well as vitamins and food supplements, under its own labels and trademarks, to distributors and dealers located throughout the United States. In addition, respondent corporation sells over 300 products manufactured by and bearing the name and label of other manufacturers. These products are of a wide variety including clothing, household appliances, furnishings, tools, luggage, watches, cameras and other items. Sales of products by the respondent corporation is more than $150,000,000 at retail levels, and over 200,000 persons are actively engaged in the resale of Amway products throughout the United States. [3]

PAR. 6. In the course and conduct of its business of manufacturing and distributing its products, respondent corporation ships or causes such products to be shipped from the state in which they are manufactured and warehoused to distributors or dealers located in various other States throughout the United States. These distributors in turn resell to other distributors, dealers or to members of the general public. There is now and has been for several years last past a constant, substantial, and increasing flow of such products in or

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affecting "commerce" as that term is defined in the Federal Trade Commission Act.

PAR. 7. Except to the extent that actual and potential competition has been lessened, hampered, restricted and restrained by reason of the practices hereinafter alleged, respondent corporation's distributors and dealers, in the course and conduct of their business of distributing, offering for sale, and selling their products are in substantial actual competition or potential competition in commerce with one another, and corporate respondent is in substantial actual or potential competition in commerce with other persons or firms engaged in the manufacture, sale and distribution of similar merchandise.

PAR. 8. Respondents have formulated a distribution system which has been published in various manuals, bulletins, pamphlets and other literature and material. To effectuate and carry out the policies of this distribution system, corporate respondent has entered into contracts, agreements, combinations or common understandings with its distributors and dealers; and has adopted, placed into effect, enforced and carried out, by various methods and means, said distribution system, which hinders, frustrates, restrains, suppresses and eliminates competition in the offering for sale, distribution and sale of its various products.

PAR. 9. Distributors and dealers of respondent corporation are independent contractors who sell or attempt to sell at retail to members of the consuming public, and at wholesale to other distributors and dealers recruited and/or sponsored into their respective sales organizations. Except for "Direct Distributors," distributors or dealers generally purchase their product needs directly from their sponsors. [4]

Distributors buying directly from respondent corporation are denoted "Direct Distributors," of which there are approximately fifteen hundred (1500) throughout the United States. Other distributors or dealers may purchase directly from Amway Corporation after meeting certain conditions.

In concert and combination with their network of distributors and dealers, respondents police, enforce and carry out the various rules, regulations and policies, including those alleged hereinafter as unfair methods of competition and unfair or deceptive acts or practices.

COUNT I

Paragraphs One through Nine are incorporated by reference herein as if fully set forth verbatim.

PAR. 10. The acts, practices and methods of competition engaged in, followed, pursued or adopted by respondents, and the combination, conspiracy, agreement or common understanding entered into or reached between and among the respondents, respondent corporation's distributors or dealers, or others not parties hereto tend to, and do, fix, maintain, control or tamper with the resale prices at which respondent corporation's products are or may be sold.

PAR. 11. For example, distributors and dealers have entered into contracts, agreements, combinations or understandings with respondents, or have been and continue to be required and coerced by respondents to sell to other distributors or dealers at other wholesale levels of distribution at the same prices which they paid for their products from other distributors or dealers or from respondent Amway Corporation. Distributors or dealers must thereafter rely upon the implementation of and adherence to respondents' purchase volume refund schedule for wholesale profits.

Under this purchase volume refund plan, refunds are paid by respondent Amway Corporation to its direct buying "Direct Distributors" on a monthly basis at the rate of 25% of the monthly dollar volume of purchases figured at the retail price. These sponsoring distributors, in turn, pay rebates to their wholesale customers of from 0 to 25%, based upon their own monthly dollar volume of purchases, and so on, to all wholesale levels of distribution. [5]

PAR. 12. By way of further example, distributors and dealers have also agreed to sell to church, service, civic or charitable selling organizations at specified prices, and to in turn request these organizations to adhere to these same retail prices when selling to the ultimate consumer. Thereafter the distributor or dealer will pay the selling organization a sum of money which will become its gross income on the aforesaid sales.

Said acts, practices and methods of competition, and the adverse competitive effects resulting therefrom, constitute unreasonable restraints of trade and unfair methods of competition in commerce within the intent and meaning of Section 5 of the Federal Trade Commission Act, as amended.

COUNT II

Paragraphs One through Nine are incorporated by reference herein as if fully set forth verbatim.

PAR. 13. The acts, practices and methods of competition engaged in, followed, pursued or adopted by respondents, and the combination, conspiracy, agreements or common understandings entered into or reached between and among the respondents, respondent corporation's distributors or dealers, or others not parties hereto tend to, and do, restrict the customers to whom respondent corporation's distributors or dealers may resell their products; restrict distributors and dealers as to the source of their product needs; restrict the retail outlets through which distributors and dealers may resell their products; and allocate retail customers between and among the various distributors or dealers.

PAR. 14. Distributors and dealers have entered into contracts, agreements, combinations or understandings with respondents, or have been and continue to be required and coerced by respondents to adhere to practices whereby absent prior approval to the contrary, purchases of product needs must be made either directly from respondent corporation or from the distributor or dealer who recruited and/or [6] sponsored the would-be purchasing distributor or dealer. Distributors and dealers may not resell their products at wholesale except to those other distributors or dealers they had recruited and/or sponsored, and who are recognized as such by respondents. Distributors or dealers who drop out of the program are replaced in the chain of distribution by other distributors or dealers to whom the former had previously been selling.

PAR. 15. Distributors and dealers have also entered into contracts, agreements, combinations or understandings with respondents, or have been and continue to be required and coerced by respondents to refrain from selling from or through any business office, retail store, military store, ship's store, service station, barber shop, beauty salon, show booth, fair or the like, and to refrain from selling to proprietors of such establishments for resale at the retail level.

PAR. 16. Distributors and dealers have also entered into contracts, agreements, combinations or understandings with respondents, or have been required and coerced by respondents to refrain from soliciting the business of retail customers and commercial accounts of other distributors or dealers.

Said acts, practices and methods of competition, and the adverse competitive effects resulting therefrom, constitute unreasonable restraints of trade and unfair methods of competition in commerce within the intent and meaning of Section 5 of the Federal Trade Commission Act, as amended.

COUNT III

Paragraphs One through Nine are incorporated by reference herein as if fully set forth verbatim.

PAR. 17. The acts, practices and methods of competition engaged in, followed, pursued or adopted by respondents, and the combination, conspiracy, agreements or common understandings entered into or reached between and among the respondents, respondent corporation's distributors or dealers, or others not parties hereto tend to, and do, restrict the advertising and promotional activities in which distributors and dealers may or would otherwise engage. [7]

PAR. 18. Distributors and dealers have entered into contracts, agreements, combinations or understandings with respondents, or have been required and coerced by respondents to refrain from engaging in or limiting advertising activities as follows:

1. Distributors and dealers may not display literature or merchandise in the locations from which retail sales activities are prohibited.
2. "Direct Distributors" only may display the "Amway" tradename, tradmarks or logos on the exterior of their places of business; provided that in addition thereto the place of business is a commercial type building, the place of business is an exclusively Amway business, no displays appear in any show windows, a view from the outside looking in is obscured, and "Wholesale Only" must appear on the door leading in.
3. Distributors and dealers other than "Direct Distributors" must obtain the permission of the Direct Distributors from whose chain of distribution they purchase merchandise before the Amway logo may be displayed on business vehicles.
4. "Direct Distributors," with prior permission, may advertise in the "white pages" of the telephone directory under the "Amway" tradename, whereas other distributors or dealers may not.
5. Distributors and dealers may not utilize display ads in "yellow pages" telephone directories wherein it is indicated that the distributor or dealer deals in Amway merchandise.
6. Distributors and dealers may not set up displays at fairs, home shows or other special events unless they do so in concert, and under the direction of a "Direct Distributor." [8]
7. "Direct Distributors" only may utilize roadside advertising.
8. Distributors and dealers other than "Direct Distributors" may not advertise in newspapers, magazines or on the radio or television.
9. Distributors and dealers may only place recruiting ads which do not mention the name "Amway."
10. Distributors and dealers may not advertise specific Amway products in the media.

Said acts, practices and methods of competition, and the adverse competitive effects resulting therefrom, constitute unreasonable restraints of trade and unfair methods of competition in commerce within the intent and meaning of Section 5 of the Federal Trade Commission Act, as amended.

COUNT IV

Paragraphs One through Nine are incorporated by reference herein as if fully set forth verbatim.

PAR. 19. By and through the use of written or oral representations, respondents or their representatives represent and have represented, directly or by implication that:

1. Substantial income or profit as a result of wholesale or retail sales activities from "multiplication," "duplication" or geometrical increases in the number of distributors at lower functional levels of distribution is likely.

2. Substantial income or profit as a result of wholesale or retail sales activities from unlimited recruiting activities or endless chain recruiting activities is likely. [9]

PAR. 20. In truth and in fact the distributors and dealers are not long likely to recruit other distributors in multiplication, duplication, geometrically increasing, unlimited or endless chain fashion, or to profit from sales to other distributors at lower functional levels in geometrically increasing, unlimited, or endless chain fashion because:

(a) The participants may be, and in a substantial number of instances will be, unable to find additional participants, by the time they enter respondents' marketing program. As to each of the individual participants, recruitment of additional participants must of necessity ultimately collapse when the number of persons theretofore recruited has so saturated the area with distributors or dealers as to render it virtually impossible to recruit others.

(b) Profits resulting from respondents' recruitment program must of necessity ultimately collapse when the number of potentially available persons who can be recruited to serve a particular area is exhausted. The greater the number of distributors or dealers previously recruited, the lower the chances of a profitable distributorship or dealership operation.

(c) Regardless of the number of distributors or dealers previously recruited to serve in a particular market area, profits and therefore recruitment must of necessity ultimately collapse when distributors or dealers at lower functional levels of distribution are unable to operate their wholesale businesses at a profit by selling to lower functional levels at prices greater than paid for. The greater the number of levels of distribution, the more inefficient the distribution system becomes, and the less profitable it is likely to be at the lower levels. [10]

For the foregoing reasons and others, respondents' representations that substantial income or profit may be predicated through multiplication, duplication, and geometrical, unlimited or endless chain increases in the number of distributors or dealers recruited, either at the same or lower functional levels of distribution, in connection with the manufacture, sale and distribution of their merchandise, was and is false, misleading and deceptive, and was and is an unfair method of competition and an unfair act and practice within the intent and meaning of Section 5 of the Federal Trade Commission Act, as amended.

COUNT V

Paragraphs One through Nine and Paragraphs Nineteen and Twenty are incorporated by reference herein as if fully set forth verbatim.

PAR. 21. In the course and conduct of their business, and for the purpose of inducing the purchase of their products and the participation of persons as dealers or distributors of respondents' products, the respondents and their representatives or agents have made and are continuing to make oral and written statements and representations to distributors, dealers and prospective participants regarding the sale of their merchandise, the profitability of a dealership or distributorship and the recruitment of still additional participants. Typical and illustrative of said statements and representations, but not all inclusive thereof, are the following (with emphasis omitted):

1. Sponsoring is profitable, regardless of whether you do it on a limited basis as a part-time distributor, or "all-out" as a full-time distributor.

2. Sponsoring is easy! Recruiting new Amway Distributors is not difficult, just as selling Amway products is not difficult. . . .When you have learned to sponsor one, then you simply repeat the process and sponsor two. . . .From that point on, it is just simple multiplication!

3. . . .[T]here is no known limit to how big your business can grow when you sponsor other distributors, who in turn sell products and sponsor still other distributors.

4. With the proven Amway Opportunity success will be yours. . .act now. . . .

5. To build a big business you, plus your 10 distributors-each sponsoring 4 people (total 51 distributors) with everyone selling one hour per day you will earn. . .your total monthly profit $1,368.00. Excellent income for one hour per day. [11]

6. To build a larger business. . .you simply sponsor 10 distributors who work. . .one hour per day. . .You will earn. . .Your total monthly profit. . .$264.00. Great income for one hour per day.

7. By working just one hour per day and making 2 average sales of $4.00 PV each, . . . your total monthly profit . . . .$52.80. Good extra income for one hour per day."

8. How much can I earn? As much as you desire.

9. Amway six year plan for financial independence. Step 1 - become a direct distributor. . . Step 2 - develop one direct distributor per year. . . Annual income after 6 years $24,300.00.

10. Assuming that you become a Direct Distributor within a year's time and that you develop a Direct Distributor each year for the next five years, at the end of six years you can be earning in Direct Distributor bonuses $225 x 5, or a total of $1,125 a month. . . .The $1,069 a month which you receive on your personal group and the 3% refund bonuses of $1,125 on the 5 Direct Distributors whom you personally sponsor will amount to $2,194 a month or a total of $26,328 a year. This is gross income for managing a business of your own. This can be your six-year plan for financial independence.

11. You can realize the achievement of your dreams through the Amway Opportunity. The Amway Opportunity is broad enough for you to achieve whatever your goal is.

12. An Amway pattern for success. . .duplicate yourself. You sponsor 1 distributor each month . . . each of your personally sponsored distributors sponsor 1 distributor each month - up to 6 . . . . at the end of one year. . . . Your personal group would consist of 64 distributors.

13. To build a still bigger business. . . .You, plus your 6 distributors each sponsoring 4 people (total 31 distributors) with everyone selling $5.00 PV per day. . .you will earn. . .your total monthly income. . . . $408. Excellent income for only a few hours per day.

14. With Amway, you start earning money right away with no large inventory investment.

15. The market potential for Amway products is spectacular.

16. Let's say that six of your personally sponsored distributors sponsor four distributors each, and that everyone makes a sale a day. . . . [12]

17. Let's say you have sponsored six distributors. . . . Your distributor organization can look like this:

Your Sponsor
1
You $200 (Retailing)
1
A $300
B $100
C $150
D $50
E $200
F $100

Your total group PV $1,100.00
Total monthly gross income $157.50

As your business continues to grow and as you train and motivate your personally sponsored distributors to retail and to duplicate themselves by sponsoring new distributors, here is how your total PV and income can increase:

Your Sponsor
1
You $200 (Retailing)
1
Dist A and his group $600
Dist B and his group $300
Dist C and his group $200
Dist D and his group $250
Dist E and his group $300
Dist F and his group $400

Your total group PV $2,250.00
Total monthly gross income: $270.00

At this point, your business has started to bring you good returns. Although you should have sponsored additional distributors in the meantime, for the purposes of simplication, we will show only six distributors personally sponsored by you. Your part-time business can expand rapidly from this point onward.

. . .Your income picture for the month can now look like this:

Your Sponsor
1
You $200 (Retailing)
1
Dist A and his group $1,000
Dist B and his group $1,500
Dist C and his group $800
Dist D and his group $500
Dist E and his group $300
Dist F and his group $800

Your total group PV $5,100.00
Total monthly gross income $594.00

[13] 18. The income picture! Let's take a look at your income picture for the month. . . . Immediate income on your personal sales of $200. . . . $60. Income on refund:. . . . $114. Total earnings $174.

If you save $174 a month for six months, you'd have a total of $1,044 toward a Carribean or a South Seas vacation. . . . So for example, five of your distributors sponsor four distributors who each sell $200 for the month. Now the total of your group has grown to 26, and your monthly purchase volume is $5,200. . . . However, your earnings picture for the month can now look like this: Immediate income on your personal sales $60. Refund income . . . $492. Total earnings $552. Thus, you now have an attractive part-time income, and yet this is just the beginning.

PAR. 22. By and through the use of the above quoted statements and representations, as well as other oral and written statements and representations as found in various promotional materials not expressly set out herein, respondents and their representatives or agents represent, and have represented, directly or by implication, to distributors, dealers and prospective participants, that:

1. It is easy for distributors or dealers to recruit and/or retain

persons to participate in the program as distributors, dealers or sales personnel.

2. Distributors or dealers in the program can anticipate receiving or will receive substantial profits or earnings.

PAR. 23. In truth and in fact:

1. It is not as easy as respondents represent for distributors or dealers to recruit and/or retain as distributors, dealers or sales personnel persons who will participate in the sales program.

2. Distributors or dealers in the sales program do not receive nor are likely to receive the substantial profits or earnings that respondents represent that they will receive or are likely to receive. [14]

PAR. 24. The following statements constitute material facts with respect to the making of claims or representations regarding the potential for recruitment of prospective distributors or dealers and/or the profitability of a distributorship or dealership:

1. There is a substantial turnover or dropout rate of distributors, dealers, wholesale and retail sales personnel, and a constant recruitment effort must be made simply to maintain a constant number of sub-distributors, sub-dealers, or sales personnel.

2. There are substantial business expenses associated with an active Amway distributorship or dealership.

PAR. 25. The statements and representations contained in Paragraph Twenty-One, along with other statements and representations not expressly referred to therein, contain claims regarding the potential for recruitment of prospective distributors, dealers or sales personnel and the profitability of a distributorship or dealership; but fail to disclose the material facts set forth in Paragraph Twenty-Four.

The dissemination by respondents of the aforesaid statements and representations, and others, has had, and continues to have, the capacity and tendency to mislead distributors, dealers and prospective participants into the erroneous and mistaken belief that:

1. There is no substantial turnover of distributors, dealers or sales personnel.

2. The turnover of distributors, dealers or sales personnel is not as substantial as they would otherwise have been led to believe.

3. There are no substantial business expenses incurred by distributors or dealers.

4. The business expenses of distributors or dealers are not as substantial as they would otherwise have been led to believe. [15]

PAR. 26. For all of the foregoing reasons, and others, respondents' statements and representations as set forth in Paragraph Twenty-One, as well as others not expressly referred to therein, in connection with the manufacture, sale and distribution of their merchandise, are false, misleading and deceptive, and were and are unfair methods of competition and unfair or deceptive acts or practices within the intent and meaning of Section 5 of the Federal Trade Commission Act, as amended.

INITIAL DECISION BY JAMES P. TIMONY, ADMINISTRATIVE LAW JUDGE

JUNE 23, 1978

PRELIMINARY STATEMENT

By a Federal Trade Commission complaint issued on March 25, 1975, respondents Amway Corporation ("Amway"), Amway Distributors Association of the United States ("ADA"), Jay Van Andel and Richard M. DeVos are charged in five counts with violations of Section 5 of the Federal Trade Commission Act, 15 U.S.C. 45. [2]

Respondent Amway is a corporation organized less than twenty years ago by respondents Van Andel and DeVos. Amway manufactures, distributes and sells with its own trademarks over 150 products, including primarily cleaning and personal care products, and food supplements. While Amway started with soap and other cleaning products, it now sells a wide variety of low cost consumer products, including catalog sales of over 300 products manufactured by and bearing the names of other manufacturers, such as clothing, household appliances, furnishings, tools, luggage, watches and cameras. Amway sells such products through more than 300,000 independent distributors throughout the country. These distributors engage in direct, house-to-house sales to consumers, with total sales amounting to over $200 million in fiscal 1976. The distributors also seek new distributors to build a sales organization. As an incentive to the distributors' sales, Amway offers, *inter alia,* volume discounts based on the total sales of a distributor's sales organization, ranging from 3% on monthly sales over $100 to 25% on sales of about $8,500 and over. Once the distributors reach the top discount bracket, they become "Direct Distributors," receiving such benefits as dealing directly with Amway (rather than through the distributors which sponsored them), and voting membership in the distributors' association, ADA.

The ADA is an association of about 2,500 Amway Direct Distributors, acting as a consultant to Amway on proposed changes in basic sales policies of Amway and as a board of arbitration in disputes between and among distributors and as an appeal board with respect to action by Amway which may affect the rights of distributors.

Amway has a distribution plan published in various manuals, bulletins, pamphlets and other literature and material. This plan, known as the Amway Sales and Marketing Plan, imposes certain limitations upon the distributors' resale of products purchased from Amway and upon the method of recruiting new distributors. The complaint in this case attacks these limitations. Count I of the complaint alleges that respondents engage in resale price maintenance. [3] Count II alleges that respondents allocate customers among distributors and restrict the distributors' source of supply as well as the retail outlets through which they may resell. Count III alleges that respondents restrict the distributors' advertising. Count IV alleges that respondents misrepresent that substantial income may be obtained from geometrical increases in the number of distributors in the chain recruiting operation of the Amway distribution plan. Count V alleges that respondents misrepresent the profitability of a distributorship and the potential for recruiting new distributors and fail to disclose the substantial business expense involved and the high turnover of distributors.

By an answer filed on August 28, 1975, respondents admitted in part and denied in part the various allegations of the complaint. Respondents moved to dismiss the complaint on the grounds that: (1) evidence was improperly obtained by the staff during the course of the pre-complaint investigation, and (2) respondents were not afforded an opportunity to negotiate a settlement prior to the issuance of the complaint. The motion was certified to the Commission by an order dated September 16, 1975; the motion was denied. By an order dated April 12, 1976, I was substituted as administrative law judge because of the heavy workload of the former administrative law judge. An active motion practice ensued, with some thirty contested pretrail orders being issued on a number of procedural question.[1] [4]

Discovery was extensive, involving depositions, interrogatories, requests for admission, and pretrial subpoenas. Counsel filed lists of

[1] Many of respondents' allegations of procedural misconduct were repeated by respondents' counsel on the first day of the trial and are the subject of an additional order, recently entered herein, denying respondents' motion to dismiss.

witnesses and narrative statements of their proposed testimony and exchanged documents to be offered in evidence. The parties filed written statements of relevancy and opposition concerning the offer of hundreds of proposed Commission exhibits. Complaint counsel filed an extensive pretrial statement and proposed findings. The parties filed pretrial briefs.

Hearings started May 16, 1977. The case-in-chief ended on June 7, 1977. The defense started June 28, 1977, and concluded on July 29, 1977. Complaint counsel had a rebuttal case on October 4, 1977. About 150 witnesses testified and the record consists of almost seven thousand pages of transcript and over one thousand exhibits.

Since the last witness testified, the parties have resumed the motion practice, with about thirty additional post-trial contested motions. One of the contested issues involved twenty-three tape recordings received as exhibits during the trial on condition that transcripts be prepared and offered as exhibits. The parties were long at issue over the content of the transcripts of the tapes. The transcripts, when completed, made a pile "two or three feet high." Six full transcripts and seventeen partial transcripts of the tape recordings eventually were offered and received as exhibits.[2] [5]

The post-trial briefs and proposed findings amounted to about 1600 pages. Oral argument was heard on June 6, 1978.

The findings of fact include references to the principal supporting evidence in the record. Such references are intended to serve as convenient guides to the testimony and exhibits supporting the findings of fact, but do not necessarily represent complete summaries of the evidence considered in arriving at such findings. The following abbreviations have been used:

CX – Commission's Exhibit, followed by number of exhibit being referenced.
RX – Respondents' Exhibit, followed by number of exhibit being referenced.
Tr. – Transcript, preceded by the name of the witness, followed by the page number.
CPF – Proposed Finding submitted by Complaint Counsel.
CB – Complaint Counsel's Brief.
CRB – Complaint Counsel's Reply Brief.
RPF – Respondents' Proposed Findings.

[2] Another reason for the delay in closing the record involved the condition of the record. Numerous exhibits were lost or misplaced. At least sixty exhibits had to be replaced with substitutes. The transcript of testimony had numerous errors. Almost all of the changes were stipulated by the parties. The reporter is submitting corrected pages of the transcript during the time that this decision is being prepared, too late for reference herein. Eleven orders were entered concerning this subject, *e.g.*, orders dated March 16, 1978, and June 15, 1978 (denying motion to dismiss of June 6, 1978).

RB - Respondents' Brief. [6]

FINDINGS OF FACT

Respondents

1. Respondent Amway Corporation (Amway) is a corporation organized and existing under the laws of the State of Michigan, with its home office and principal place of business at 7575 East Fulton Rd., Ada, Michigan. (Answer, p. 5)

2. Amway currently manufactures and sells more than 150 kinds of home care, car care and personal care products, as well as vitamins and food supplements, all of which are sold under its own labels and trademarks. (Answer, p. 4)

3. The products which Amway sells to its distributors may be grouped into seven major categories as follows: home care and cleaning products; personal care products (such as cosmetics); food supplements; cookware and cutlery; commercial and agricultural products; catalog sales (a wide variety of products); and safety products (such as smoke detectors and fire extinguishers). Soap and detergents account for 41.2% of Amway's 1974 sales; polishes and sanitation goods 20%; and toilet preparations 6.5%. (RX 405)

4. Through its Personal Shoppers Catalog, Amway sells over 300 products manufactured by and bearing the name of other manufacturers. These products include clothes, household appliances, furnishings, tools, luggage, watches, and cameras. (CX 640)

5. Amway distributes its products in the United States through direct selling by authorized independent distributors, which in 1977 numbered approximately 360,000. (RX 383) [7]

6. Amway's dollar volume in sales to distributors in fiscal 1976 was approximately $169 million in the United States and $205 million worldwide. (RX 448; RX 431; Halliday, Tr. 6103, 6105-16)

7. Respondents Jay Van Andel and Richard M. DeVos are co-founders and, together with their wives, are principal owners of Amway. (Van Andel, Tr. 1672, 1781)

8. Mr. Van Andel is Chairman of the Board of Amway. (Van Andel, Tr. 1671)

9. Mr. DeVos is President of Amway. (Complaint, ¶4; Answer, p. 4)

10. Amway's Board of Directors consists of Mr. Van Andel, Mr. DeVos, and William J. Halliday, Jr. (Van Andel, Tr. 1781-82)

11. Respondent Amway Distributors Association of the United States (ADA) is a trade association of Amway distributors organized and existing as a non-profit corporation under Michigan Law.

(Halliday, Tr. 6091–92, 6171–73) ADA maintains its home office and principal place of business at 7575 East Fulton Road, Ada, Michigan. (Complaint, ¶2; Answer)

12. Each new Amway distributor may choose to become a member of the ADA. (Halliday, Tr. 6195–96)

13. An Amway distributor who, through sales volume and other requirements, becomes a "Direct Distributor" may qualify as a voting member of the ADA. (Halliday, Tr. 6196–97) [8]

14. There currently are about 2500 voting members of the ADA. (Halliday, Tr. 6555–56)

15. Voting members of the ADA elect nine members of the eleven-member ADA Board of Directors and Amway appoints two members. Mr. Van Andel and Mr. DeVos represent Amway on the Board. (Halliday Tr. 6194)

16. The ADA Board performs three principal functions: (a) it acts as a representative of the distributor association; (b) it acts as an advisory board to Amway; and (c) it acts as an arbitration board in disputes between distributors or between Amway and a distributor. (Halliday, Tr. 6175–83)

Organization History

17. Mr. Van Andel and Mr. DeVos have been involved in direct selling since 1949, beginning as distributors of Nutrilite food supplements, through a corporation they organized for this purpose—the Ja-Ri Corporation. (Van Andel, Tr. 1672–73, 1676, 1908–10)

18. Direct selling is the distribution of products and related services to consumers in their homes through person-to-person selling. (Van Andel, Tr. 1691–92; Granfield, Tr. 2917–18)

19. In 1959, Mr. Van Andel and Mr. DeVos and other distributors had trouble with their suppliers of food supplements, Nutrilite Products Company, Inc., and Mytinger & Castleberry, Inc. A small group of distributors was appointed, with Mr. Van Andel as the chairman, to try to work out an arrangement with the suppliers. The negotiations culminated in an offer by one of the suppliers to Mr. Van Andel to become president of the company. Mr. Van Andel and Mr. DeVos concluded that the inherent problems were with the people who owned those companies and that those problems would continue regardless of who managed them. Mr. Van Andel refused the offer. (Van Andel, Tr. 1672–73) [9]

20. Mr. Van Andel and Mr. DeVos decided that their suppliers were in great danger of collapsing and that they should go into the business themselves, producing their own products and selling them through the Ja-Ri sales organization which had more than 2000

distributors as members. (Van Andel, Tr. 1674; 1679; Hansen, Tr. 3302; CX 904)

21. Mr. Van Andel and Mr. DeVos then put together an organization of distributors called the American Way Association, the name of which was later changed to the Amway Distributors Association. The primary purpose of this organization was to allow Mr. Van Andel and Mr. DeVos to communicate with their Nutrilite distributors in the Ja-Ri organization and to hold the business together until Mr. Van Andel and Mr. DeVos could develop their own manufacturing operation. (Van Andel, Tr. 1674-75)

22. Mr. Van Andel and Mr. DeVos had to be very careful in changing their distributor organization, with its allegiance to Nutrilite food supplement products. Since the distributors were independent, they might quit. It was therefore necessary for Mr. Van Andel and Mr. DeVos to have these distributors concur in their plans to set up a product distribution and manufacturing operation; and they discussed the type of products they intended to produce with the distributors' association. (Van Andel, Tr. 1674-76) Many of the distributors in the organization of Mr. Van Andel and Mr. DeVos joined the American Way Association, and began distributing products sold to them by Amway as well as Nutrilite products. In 1972, Amway acquired 51% of Nutrilite. (Van Andel, Tr. 1679-80, 1684-85)

23. Mr. Van Andel and Mr. DeVos decided to look for products which were readily consumable, relatively low-priced, different from those found in retail stores, and which would lead to repeat sales. They chose soap and detergents because they felt it would be the easiest market to train distributors to sell in. With that type of product, it is a matter of which one to use rather than whether to use it at all. (Halliday, Tr. 6541; Van Andel, Tr. 1680-81) [10]

24. At about the same time that the American Way Association was formed, Mr. Van Andel and Mr. DeVos began distributing through the Ja-Ri organization a liquid detergent called "Frisk" which they renamed "LOC" (liquid organic compound) and which is still one of the principal Amway products. This product was manufactured by Eckle Company, a small supplier in Detroit, Michigan, and it was one of the only biodegradable liquid detergents available at that time. Mr. Van Andel and Mr. DeVos, through Ja-Ri Corporation, acquired the company, moved the assets to Ada, Michigan, and changed its name to Amway Manufacturing Company. A few months later they introduced SA8, a biodegradable powder detergent. (Van Andel, Tr. 1673-78; Halliday, Tr. 6153, 6541)

25. In November 1959, Mr. Van Andel and Mr. DeVos organized

Amway Sales Corporation and Amway Services Corporation. (Van Andel, Tr. 1677) In November 1963 the name of Ja-Ri Corporation, Inc., was changed to Amway Corporation; and on January 1, 1964, Amway Sales Corporation, Amway Service Corporation, and Amway Manufacturing Corporation were merged into Amway. (Answer, p. 3)

Amway Distribution System

Amway Distributors

26. The Amway Sales and Marketing Plan is designed to move products manufactured by or for Amway through a network of distributors to retail customers. (Halliday, Tr. 6198) Amway imposes several restraints upon distributors as part of this system. The restraints, which are the subject of this litigation, are found in Amway's "Code of Ethics and Rules of Conduct." (RX 331, pp. 13-B through 25-B) The Amway system of recruiting, sponsoring and selling basically is the same as the Nutrilite system which began operating in 1946. (Van Andel, Tr. 1702, 1905-08) [11]

27. The Amway Sales and Marketing plan involves person-to-person retail selling. Amway distributors are urged to sell at retail to persons they know or are referred to, rather than going from door-to-door. (Van Andel, Tr. 1757-58)

28. In the Amway Sales and Marketing Plan, products are sold by Amway distributors, all of whom are independent contractors. (Halliday, Tr. 6261-62)

29. All new Amway distributors enter the business with the same rights and obligations. (Halliday, Tr. 6208; Lemier, Tr. 210-11)

30. Each Amway distributor has the right to sell Amway products to consumers and to sponsor new Amway distributors and to sell products to his sponsored distributors. (Van Andel, Tr. 1708)

31. Any Amway distributor may become a "Direct Distributor" by qualifying on the basis of sales volume. The principal requirement for qualification as a Direct Distributor is that the distributor must have a sales volume of about $8500 per month. (RX 331, p. 8-D

32. Amway sells its products to Direct Distributors, who sel Amway products to consumers and to their sponsored distributo for resale. (S. Bryant, Tr. 4033-34) Other distributors normally bı from their sponsor. (RX 331, p. 1-E) Those distributors ("Warehou Order Distributors"), living more than 25 miles from their source supply or doing a large volume, are authorized to buy directly fr Amway. (RX 331, p. 1-E) [12]

33. In order to become a duly authorized Amway distributo person must (a) be sponsored by an Amway distributor, and (b)

an application with Amway for the right to sell Amway products. (Van Andel, Tr. 1696–97; RX 331, p. 14–B)

34. A new Amway distributor is not required to buy inventory. The distributor need only buy a $15.60 "Sales Kit" containing product information and sales aids and literature. (RX 331, p. 15–B; Halliday, Tr. 6615)

35. A new distributor may also purchase an optional "Product Kit" for $25.65, containing sample Amway products for demonstration use. (Halliday, Tr. 6126, 6588; RX 433)

36. Neither Amway nor sponsoring distributors make a profit on the Sales Kits. (Van Andel, Tr. 1863, 1937; Max, Tr. 5996; Garmon, Tr. 3515)

37. A distributor who decides to leave the business may receive a refund on the price of the Sales Kit and Product Kit. (Halliday, Tr. 6615)

38. Most new Amway distributors have had no selling or business experience. (CX 1000–K; Van Andel, Tr. 1695)

39. The vast majority of Amway distributors, including Direct Distributors, conduct the Amway business on a part-time basis, and have another full-time occupation. (Halliday, Tr. 6235; RX 329) [13]

40. Anyone who has become an Amway distributor prior to August 31 of any year or who has continued his distributorship for that year must renew his distributorship authorization for the next year by December 31. (Halliday, Tr. 6484)

41. The number of active distributors since 1972 has remained relatively constant, fluctuating around 300,000, climbing in 1977 to about 360,000. (RX 383)

42. The average annual turnover of Amway distributors is about 50%. The turnover rate for Amway distributors during their first year is almost 75% and thereafter about 25% a year. (CX 909; RX 83)

43. Currently about half of all Amway distributors were sponsored by a Direct Distributor or by a distributor sponsored by a rect Distributor. More than 70% were within three positions of a rect Distributor and 99% were within seven positions. (RX 423)

44. If distributors leave Amway, any distributors whom they may e sponsored move up the line of sponsorship to the next qualified ributor. (RX 331, p. 17–B)

. In order to receive the benefits of sponsoring, Amway ibutors must train their sponsored distributors and stock itory to supply them. (RX 331, pp. 17–B to 18–B)

The distributors sponsored by an Amway distributor become ers of that distributor's "personal group." The sponsored distributors may then sponsor other distributors, thereby forming their own personal groups and enlarging the personal group of the first sponsoring distributor. (CS 1096, p. 2-B) [14]

47. When distributors qualify as Direct Distributors, they "break off" from the personal group of their sponsor, thereafter dealing directly with Amway. (RX 331, p. 8-B)

48. The Amway Sales and Marketing Plan provides communication with distributors through literature published by Amway and by meetings. About 10 or 15 times a year sales rallies consisting of several thousand distributors are held around the country, to which any distributor in the area is invited. An afternoon meeting for high volume distributors only (with no guests allowed) is followed by an evening sales rally for all distributors and their guests. (Van Andel, Tr. 1761-63) These evening sales rallies involve presentation of sales awards with impromptu speeches by the recipients and motivational speeches by other successful distributors and celebrities. "Amway officials are present to offer helpful advice to both new and experienced distributors alike." (*Id.;* CX 62-Z-42 - 43) Area meetings are produced independently by Direct Distributors for their groups or for a combination of Direct Distributor groups. They provide information and inspiration for the distributors. (CX 62-Z-43)

49. About five thousand distributor-operated meetings are held each week. These local meetings help sponsors "build enthusiasm within their group through weekly meetings in their homes or offices for the purpose of training, motivating and sponsoring." (CX 62-Z-43)

Compensation

50. Amway distributors earn income from retail sales through the "basic discount" (the difference between the price paid by the distributor for the product and the price charged by the distributor at retail). A distributor does not make money directly by selling products to his sponsored distributors "because he sells them for the same price he paid for them; the distributor cost." (RX 331, p. 3-B) Instead, distributors receive a [15] "performance bonus" which is paid by Amway through sponsoring distributors and is based on the distributor's total monthly sales volume. The "Basic Discount" and "Performance Bonus" are defined as (RX 331, p. 4-B):

Basic Discount: When you personally sell Amway products you earn income in two ways . . . the first of these is your "basic discount." You buy products from your sponsor at the wholesale price, and sell them to customers at retail. The basic discount on most home-size products is 35%, with some at 15% or 25%. That percentage is your immediate income — your "basic discount" — which you get as soon as you are paid by your customers. Most distributors average 30% of Business Volume as income.

Performance Bonus: The second way you earn income is through your monthly Performance Bonus on Amway products you purchase for resale. In addition to your immediate basic discount, you earn a Performance Bonus each month based on total Point Value and BV of all products purchased by you during the month. This is a percentage Bonus which varies from 3% to 25% depending on your total monthly Point Value, according to the schedule below.

PERFORMANCE

BONUS SCHEDULE

Performance Bonuses are paid in addition to the basic discount, which averages 30%.

IF YOUR TOTAL MONTHLY POINT VALUE* IS:	YOUR PERFORMANCE BONUS IS:
7,500 or more points	25% of your Business Volume
6,000 to 7,499 points	23% of your Business Volume
4,000 to 5,999 points	21% of your Business Volume
2,500 to 3,999 points	18% of your Business Volume
1,500 to 2,499 points	15% of your Business Volume
1,000 to 1,499 points	12% of your Business Volume [16]
600 to 999 points	9% of your Business Volume
300 to 599 points	6% of your Business Volume
100 to 299 points	3% of your Business Volume
Less than 100 points	0% of your Business Volume

* Total monthly PV includes both personal PV and PV of others you sponsor.

51. The performance bonus schedule was previously based on monthly dollar purchase volume. (CX 61, p. 4–B) In 1975, in order to adjust for inflation, each product was assigned a "point value" which remains constant regardless of changes in the price of the product. (CX 680–A)

52. Each Amway product is also assigned a dollar value for the purpose of calculating "business volume" ("BV"), corresponding approximately to the suggested resale price of the product, less a warehouse charge. (RX 331, p. 4–B)

53. The performance bonus system provides an incentive to sponsoring distributors to provide training, motivation and supply to sponsored distributors, since they receive income based on the accumulated total sales of all of the distributors in their personal group. (Van Andel, Tr. 1863–64) This payment has been termed "overwrite," "bonus," and "refund," and since 1975 "performance

bonus." (CPF 199) It corresponds to the compensation paid by manufacturers to wholesalers. (Cady, Tr. 5776-78)

54. Under the Amway Sales and Marketing Plan it is the Direct Distributors' duty to see that performance bonuses, which they receive monthly from Amway, are promptly distributed to sponsored distributors and redistributed in that month to all distributors in the Direct Distributor's personal organizations who earned the performance bonus. (RX 331, p. 19-B) Amway enforces its refund policy. (CPF 204) The ADA arbitrates disputes concerning the refund policy. (CPF 205) [17]

Sponsoring

55. The sponsoring distributors earn income on the basis of the total sales volume of their personal distributor group, as well as their own personal retail sales. (RX 331, p. 5-B) Sponsoring distributors must supply and train distributors they sponsor. (RX 331, p. 17-B)

56. Distributors are urged to sponsor new distributors in order to "earn on what others sell" (RX 331, p. 5-B), but the Amway Sales and Marketing Plan stresses that combined retail selling and sponsoring are equally essential to the distributor's success. (RX 331, p. 1-B)

57. About 25% of Amway distributors sponsor new distributors. (RX 415; Van Andel, Tr. 1828; Max, Tr. 6023)

58. Recruiting distributors occurs primarily at an "Opportunity Meeting" which each distributor is urged to hold at least once a week. (CX 68-D) Amway encourages that recruiting be done individually rather than at mass meetings. (CX 638-H) Recruiting new distributors through the presentation of the Amway Sales and Marketing Plan involves (1) introducing the company and products, (2) appealing to the financial goals of the prospective distributors, and (3) explaining the compensation of a distributor through retail and wholesale sales. (RX 331, Section D)

59. The Amway Career Manual for distributors explains how to recruit distributors by appealing to the financial goals of prospects. (RX 331, pp. 1-D to 3-D). The suggested presentation provides that the distributor should: [18]

> Announce to your guests that you would like to tell them about an exciting opportunity to be in business for themselves and to develop an income of as much as $1,000 per month. Explain that it is an opportunity that grows as they share it with others.
>
> Ask if they are as successful as they would like to be. If not, would they be interested in a chance to realize their dreams through a business of their own that

they can build on a part time basis — and, with such a modest initial expenditure? An opportunity does exist that will give them such a chance.

* * * * * * *

[The distributor is then advised to give a short history of the company and to describe some of the products and sales literature.]

* * * * * * *

What does all this mean to you? It means you can become a part of a dynamic growing organization. It means that this opportunity can mean the realization of your dreams.

(Ask questions to find out what the goals and dreams of each prospective distributor may be.)

What are some of your dreams?

Do you want a new car, a new house, college education for your children?

Do you want retirement income that will afford you a comfortable standard of living?

What income do you want six years from now?

Are you willing to work hard to get this?

How much extra money per month do you need for that new car? [19]

$100 a month or more?

What kind would you like — a Chevrolet, Pontiac, Oldsmobile?

How much money per month do you need for that new house?

What kind of home do you want — a three-bedroom ranch — with a price tag of $35,000 - $40,000?

How much will you need for monthly payments — $250, $300 a month?

How much will it take to send the youngsters through college — $2,500 to $3,000 a year for each youngster?

If you could earn an extra $250 a month, you would have an additional $3,000 a year. This might be sufficient to send one youngster through one year of college.

How much would you like as a continuing income — $1,000 a month?

Would you work for your goal?

Would you be interested if I could show you a way you can make your dreams come true?

Would you be interested in a way to achieve this on a part-time basis?

What would you be willing to give up to get this?

You can realize the achievement of your dreams through the Amway Sales and Marketing Plan. It is broad enough for you to achieve whatever your goal is. First of all, you start like everyone else — you are sponsored by another Amway distributor. You are in business *for* yourself, but not *by* yourself. You buy Amway products at wholesale from your sponsor, and you sell them at retail to your customers. (Emphasis in original.) [20]

60. The Amway Career Manual for distributors explains the nature of retail and wholesale compensation provided in the Amway Sales and Marketing Plan. (RX 331, pp. 5-B through 7-B): [21]

HOW MUCH CAN YOU EARN?

PUT IT THIS WAY . . .

for a small business of your own . . . **EXAMPLE 1:** by making only two average sales of $5.00 each per day, working less than an hour in each of 20 days per month, you can sell $200.00 BV per month.

Your 30% average immediate income on $200.00 sales (at BV)	= $60.00
Plus . . . 3% Performance Bonus on $200.00 in BV provided your monthly Point Value is 100 points or more	= 6.00
EQUALS . . . YOUR TOTAL MONTHLY INCOME . . .	$66.00

GROUP SPONSORSHIP

HOW YOU EARN ON WHAT OTHERS SELL

You have seen how you earn an immediate basic discount on each Amway product you sell and how you receive a monthly Performance Bonus based on the total Point Value and BV of all Amway products you sell. Here is still another Amway Career Opportunity: becoming a sponsor

Every Amway distributor may sponsor other distributors When you sponsor a new distributor, you become his wholesale supplier, just as your sponsor wholesales to you. Your income from sponsorship comes in the form of a greater monthly Performance Bonus percentage. Your total Point Value and BV include your personal Point Value and BV plus that of those whom you sponsor . . . when all the sales are added together you will probably be in a higher Performance Bonus percentage bracket, and thus earn a larger Performance Bonus. Out of this, you pay the distributor you sponsor his own earned Performance Bonus, but because your total Point Value and BV are greater than that of any of the distributors you sponsor, you will usually earn a larger Performance Bonus than you pay out. You not only earn income on the BV of the distributors in your personal group, but will usually also earn a higher Performance Bonus percentage on your own personal BV.

And you earn in the same way on the new distributors that you sponsor . . . and on those they sponsor . . . and so on. You form a growing group of distributors, and every dollar of BV generated by those in your personal group is a dollar of additional BV for you.

When you're a sponsor, you're building income for your family today, potential income for your retirement, and income that may become part of your estate. That's why Amway is not "employment," but rather, a real career: a growing, repeat business of your own!

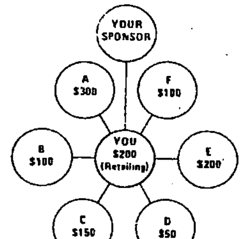
EXAMPLE 2:

Let's assume that you sponsor two other distributors and that each of the three of you sell exactly $200 (at BV) in a month, or $600 (at BV). If the Point Value of these products is at least 600 points, you will receive a $54 Performance Bonus Out of this, you pay Performance Bonuses of $6.00 to each of your personally sponsored distributors, a total of $12, leaving you $42. This plus your $60 in basic discount gives you a total income of $102 in that month.

In order to retain the right to earn Performance Bonuses on your group BV, you yourself must make not less than one sale at retail to each of 10 different customers each month and produce proof of such sales to your sponsor and Direct Distributor. This provision assists you in maintaining the balance between sponsoring and retail selling which is essential to a successful distributorship.

EXAMPLE 3:

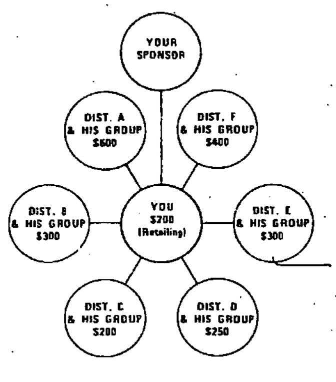
Let's say you have sponsored six distributors. The amount of BV which each will generate will probably vary depending on the length of time they have been distributors and the amount of time they have available for developing their business The following is an example of how your organization can look:



Immediate income on personal sales $200 (at BV)			$ 60.00
Your total group BV:	$1,100.00		
Performance Bonuses you receive (12%, assuming a Point Value of at least 1,000 points)		$132.00	
Performance Bonuses you pay out (assuming necessary Point Values have been achieved by each distributor)			
Distributor A (6%)	$18.00		
B (3%)	3.00		
C (3%)	4.50		
D (0%)	.00		
E (3%)	6.00		
F (3%)	3.00	−$ 34.50	
Performance Bonus you keep:			$ 97.50
Total monthly gross income.			$157.50

EXAMPLE 4:

As your business continues to grow and as you train and motivate your personally sponsored distributors to retail and to duplicate themselves by sponsoring new distributors, here is how your total BV and income can increase

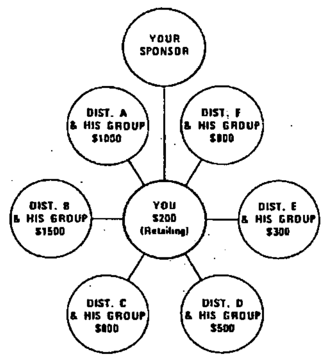


Immediate income on personal sales $200 (at BV)			$ 60.00
Your total group BV: $2,250.00			
Performance Bonuses you receive (15%, assuming Point Value of at least 1500 points)		$337.50	
Performance Bonuses you pay out (assuming necessary Point Values have been achieved by each distributor)			
Distributor A (9%)	$54.00		
B (6%)	18.00		
C (3%)	6.00		
D (3%)	7.50		
E (6%)	18.00		
F (6%)	24.00		
Total paid out		–$127.50	
(Distributors A, B, C, D, E, and F will, of course, be responsible for paying Performance Bonuses to their distributors.)			
Performance Bonus you keep:			$210.00
Total monthly gross income:			$270.00

EXAMPLE 5:

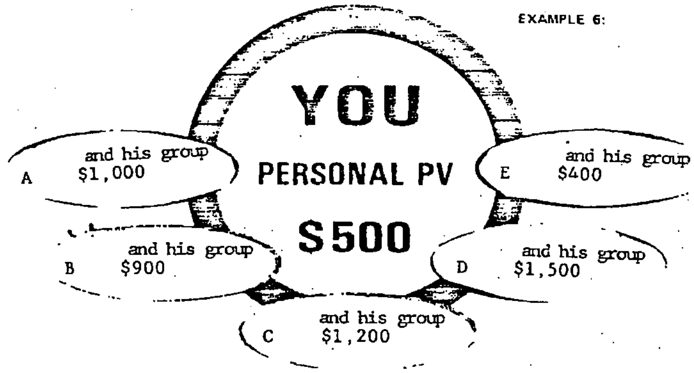
At this point, your business has started to bring you good returns. Although you should have sponsored additional distributors in the meantime, for the purposes of simplification, we will show only six distributors personally sponsored by you. Your part-time business can expand rapidly from this point onward.

As your distributors' BV grows, so does yours. Your income picture for the month can now look like this



Immediate income on personal sales $200 (at BV)			$ 60.00
Your total group BV: $5,100.00			
Performance Bonuses you receive (21%, assuming Point Value of at least 4000 points)		$1,071.00	
Performance Bonuses you pay out (assuming necessary Point Values have been achieved by each distributor)			
Distributor A (12%)	$120.00		
B (15%)	225.00		
C (9%)	72.00		
D (6%)	30.00		
E (6%)	18.00		
F (9%)	72.00		
Total paid out		–$ 537.00	
(Distributors A, B, C, D, E, and F will, of course, be responsible for paying Performance Bonuses to their distributors.)			
Performance Bonus you keep.			$534.00
Total monthly gross income:			$594.00

FULL TIME SPONSORSHIP INCOME



BUILDING TOWARD A DIRECT DISTRIBUTORSHIP

If you work consistently toward building a Sales Group of distributors and increasing your own volume of retail sales, your monthly volume can look like this. See Chart below for income breakdown. Assume that you are selling to a larger personal customer clientele who makes purchases from you totaling $500 BV of Amway products monthly Assume the distributors you sponsor have increased their retail sales and have sponsored distributors of their own so that together they contribute an additional $5,000 to your total BV. Now you are in the 21% Performance Bonus bracket, provided you have monthly total Point Value of at least 4,000 points . . . you get your basic discount on your personal BV PLUS 21% Performance Bonus on your personal BV. In addition, you will earn between 21% and the percentage Performance Bonus earned by each of your distributors on his BV. You now earn $711.

Distribution of Performance Bonus on $5,500 Total Group BV — 21%
Performance Bonus $1,155.00 (provided you have monthly total Point Value of at least 4,000 points.)

INDIVIDUAL BV	INDIVIDUAL PERFORMANCE BONUS %*	INDIVIDUAL PERFORMANCE BONUS	% PERFORMANCE BONUS LEFT FOR SPONSOR	$ PERFORMANCE BONUS LEFT FOR SPONSOR
A $1,000	12%	$120	9%	$ 90
B $ 900	9%	$ 81	12%	$108
C $1,200	12%	$144	9%	$108
D $1,500	15%	$225	6%	$ 90
E $ 400	6%	$ 24	15%	$ 60
YOU $ 500			21%	$105

TOTAL PERFORMANCE BONUS: $1,155. PAID OUT: $594 YOU KEEP $561

YOUR AVERAGE BASIC DISCOUNT $150

YOUR AVERAGE TOTAL EARNINGS $771

Note A, B, C D & E also have distributors under them helping to make total — From here it is only a short step to Direct Distributor

* Assuming necessary Point Values have been achieved by each distributor

61. Amway distributorships are not for sale and sponsoring distributors receive no profit from the act of sponsoring. It is only after the sponsored distributor begins to buy products that the sponsoring distributor will receive income. (S. Bryant, Tr. 4063)

Direct Distributors

62. A distributor may qualify as a Direct Distributor with at least 8,500 BV in a single month (assuming a point value of at least 7500 points), and with a personal group point value of at least 7500 points or more for the following two consecutive months, with a gross profit of at least $800 for each of the three consecutive months. (RX 331, p. 8–D)

63. A Direct Distributor becomes eligible for voting membership in the Amway Distributors Association and qualifies for the 3% Direct Distributor Bonus, and Sales Training Bonus, and the Profit Sharing Bonus. (RX 331, pp. 8 and 9–B)

64. Direct Distributors receive 3% of the personal group Business Volume of the Direct Distributors whom they sponsor. At that level both the sponsoring and the sponsored distributors are in the same performance bonus bracket—25%. Therefore, in order to provide the sponsoring distributor with an incentive to continue to motivate and train such a sponsored distributor, the extra 3% Direct Distributor Bonus is provided. To receive the 3% bonus, distributors must be qualified Direct Distributors, by having a qualifying personal group Business Volume excluding the Business Volume of Direct Distributors whom they have sponsored. (RX 331, pp. 8–B to 9–B) If the sponsor of the Direct Distributor does not qualify, then the 3% bonus goes to the next upline sponsor who meets the requirements. (S. Bryant, Tr. 4067–68) [25]

65. Amway pays a sales training bonus to Direct Distributors who sponsor three Direct Distributors for any six months in a year. (RX 331, p. 9–B)

66. Amway has each year paid a "profit sharing distribution" in the form of debenture bonds to all voting members of the Amway Distributors Association. (RX 331, p. 9–B; Halliday, Tr. 6212–13)

67. Amway supplies, trains and compensates Director Distributors. (Van Andel, Tr. 1710, 1850)

68. Direct Distributors supply, train and compensate distributors. They maintain a stock of merchandise and literature, have regular office hours, train distributors through sales meetings and advice, and enforce the Amway Rules of Conduct, including the requirement that monthly performance bonuses be distributed to all distributors in their organization. (RX 331, p. 19–B)

69. Direct Distributors are required to requalify annually on the basis of their sales volume. (RX 331, p. 19–B)

70. The number of Amway Direct Distributors in the United States has grown from about 3000 in 1972 to about 4000 in 1977. (Van Andel, Tr. 1695–96; CX 896) About half of the Direct Distributors started with Amway in the last five years. (RX 434)

71. Distributors who fail to requalify as Direct Distributors generally continue as distributors. Between 1960 and 1976, 3070 Direct Distributors failed to requalify as Direct Distributors, and at the end of that period 75% were still Amway distributors. (RX 434) [26]

Pyramid Rules

72. Amway, the Direct Distributor or the sponsoring distributor will buy back any unused marketable products from a distributor whose inventory is not moving or who wishes to leave the business. (RX 331, p. 17–B to 18–B; CX 847; CX 1076) The buy-back rule has been in existence since Amway started. (CX 1041–J) Amway enforces the buy-back rule. (CX 847; Brown, Tr. 5012–13; Bortnem, Tr. 686, 690; Soukup, Tr. 913)

73. To ensure that distributors do not attempt to secure the performance bonus solely on the basis of purchases, Amway requires that, to receive a performance bonus, distributors must resell at least 70% of the products they have purchased each month. (RX 331, pp. 16–B to 17–B) The 70% rule has been in existence since the beginning of Amway. (S. Bryant, Tr. 4086) Amway enforces the 70% rule. (Lemier, Tr. 192–93; S. Bryant, Tr. 4056–59; Halliday, Tr. 6497)

74. Amway's "ten-customer" rule provides that distributors may not receive a performance bonus unless they prove a sale to each of ten different retail customers during each month. (RX 331, pp. 1–B and 17–B) The Direct Distributors have the primary responsibility for enforcing the ten-customer rule in their own group. (S. Bryant, Tr. 4061–62) The ten-customer rule was started by Amway about 1970. Prior to that, there was a 25 sales rule which required the distributor to make 25 retail sales a month without regard to the number of customers. (S. Bryant, Tr. 4085–86) The ten-customer rule is enforced by Amway and the Direct Distributors. (CX 823; Case, Tr. 3414–15; Medina, Tr. 4197; Zizic, Tr. 4138–43; Lincecum, Tr. 1266)

75. The buy-back rule, the 70% rule, and the ten-customer rule encourage retail sales to consumers. (Van Andel, Tr. 1999–2000, 2010; Halliday, Tr. 6231–33; Lemier, Tr. 176; Cady, Tr. 5795–97) [27]

Operation of the ADA

76. The voting members of the ADA meet once a year for a one day meeting. They elect the Board members of the ADA and receive reports concerning the Amway business. (Halliday, Tr. 6174–75)

77. The ADA Board meets four times a year, usually for two days at a time. (Bass, Tr. 42)

78. Amway uses the ADA Board to receive recommendations concerning the business. Amway presents proposals for changes of rules to the Board for information and advice, and for reaction from the field. (Halliday, Tr. 6612–13)

79. Amway consults with the Amway Distributors Association, through the Board of Directors, in setting up discount and refund schedules, bonuses, and retail prices. (CX 22–B) In its 1975 annual report to the state of its incorporation, the ADA reported that its purpose was (CX 3–A): "To act as a trade ass'n for the purpose of setting policies with the company from whom purchases are made and the pricing of all products sold direct to the consumers." (*Also see* CX 4–A – B for 1971 report.) The Board of the ADA has in fact consulted with Amway about retail prices, *e.g.*, discussing in 1973 price cutting on a cookware promotion. (CX 376–B)

80. The ADA Board also acts as a board of arbitration in disputes among distributors and as an appeal board when Amway has terminated or disciplined a distributor. The ADA Board conducts formal hearings through a hearing committee of three members. Participants may attend the hearing in person and may be represented by an attorney. The hearing committee receives witness testimony and other evidence, and a transcript of the hearing is made if a participant requests it. The committee then makes a recommendation to the Board. The Board considers about 5 or 6 cases each time it meets and in about 20% of the cases the Board disagrees with Amway. Amway always has acceded to the Board's decision. (RPF 243, 244) [28]

Vertical Restrictions

Cross-Group Selling Rule

81. Amway distributors agree to sell at wholesale only to distributors they have sponsored, and to buy only from their sponsor. This restriction is known as the "cross-group selling rule": "*Rule 3. No distributor shall engage in cross-group selling.* A distributor in one line of sponsorship must buy all of his Amway products and literature supplies from or through his supplier." (RX 331, p. 15–B)

82. The cross-group selling rule provides Amway distributors with an incentive to recruit distributors and to train and motivate

them to sell Amway products, since the sponsoring distributor receives income on the sponsored distributors' sales volume. (Patty, Tr. 3111-13; Halliday, Tr. 6237-39; Van Andel, Tr. 1751) Effective sponsoring distributors keep inventory of Amway products, hold sales meetings, run contests and conduct other promotional and training activities. (RPF 159)

83. Amway distributors may transfer from one sponsor to another after being terminated or remaining inactive for six months. Amway also approves about 100 transfers of distributorships a year for other reasons. (RX 331, pp. 18-B and 19-B; Halliday, Tr. 6507-09)

84. A distributor must train and supply his sponsored distributor. If they are in different geographic locations, however, the sponsor may arrange, through his Direct Distributor, to have the sponsored distributor trained and supplied by a Direct Distributor living in the sponsored distributor's area. (RX 331, p. 17-B) In these private servicing arrangements, the two Direct Distributors determine the compensation for this service. (Van Andel, Tr. 1739-41) [29]

Retail Store Rule

85. Amway distributors agree not to sell in retail stores (RX 331, p. 16-B):

RULE 6. No distributor shall permit Amway products to be sold or displayed in retail stores, PX's, ships or military stores; nor shall he permit any product displays to appear in such locations, even if the products themselves are not for sale. No Amway literature shall be displayed in retail establishments.

A distributor who works in or owns a retail store must operate his or her Amway business separate and apart from the retail store. Such distributors must secure customers and deliver products to them in the same manner as Amway distributors who have no connection with a store. Other types of retail establishments, which are not technically stores, such as barber shops, beauty shops, etc., likewise may not be used to display Amway products.

86. Amway prohibits distributors from setting up displays or booths at fairs, home shows, or other similar special events. (RX 331, p. 23-B)

87. Amway restricts its distributors in their sales of Amway products in fund-raising drives carried on by churches, and other civic or charitable organizations, limiting the manner and time of the sales and the products to be sold. (RX 331, p. 15-B; CX 277-M – N)

88. The retail store rule gives an incentive to Amway distributors to provide services to consumers. Amway distributors go to the consumer's home, demonstrate and explain the products, help with cleaning problems "on site," and deliver the products to the consumer's home at the customer's convenience. These services are

typically unavailable from a retail store. (Schroeder, Tr. 5355–56; Bryant, Tr. 4396; Halliday, Tr. 6240–43; Max, Tr. 5893–94) [30]

89. In the absence of massive advertising to create demand, sales of Amway products in retail stores would fail. Retail stores might be willing to stock Amway products in the short run because of existing demand created by personal direct selling by Amway distributors. (Cady, Tr. 5785–86) Distributors would quit or switch their attention from consumers to stores. (Cady, Tr. 5786) Demand would therefore slow and when demand slows down there is no longer shelf space available in the store. (Van Andel, Tr. 1810–12) If Amway were to sell through retail stores, "they would destroy their direct selling capability." (Diassi, Tr. 5537–38)

Customer-Protection Rule

90. The Amway Sales and Marketing Plan formerly had a "customer protection rule," providing that, upon making a sale to a retail customer, a distributor established an exclusive right to resell to that customer for a specified period of time. (CX 60–Z–5)

RULE 1. *A distributor who completes a sale to a retail customer and registers such sale thereby establishes the exclusive right for a period of the next 30 days to re-sell that customer.*

An Amway distributor, upon completing a sale to a retail customer, thereby establishes the exclusive right to re-sell Amway products to that customer, provided he has "registered" such sale by sending a copy of the sales receipt to his Direct Distributor or *to such sponsor as the Direct Distributor may designate.* The distributor must sell the retail customer an Amway product and register that customer each 30 days in order to retain his exclusive right on a continuous basis.

In the case of a commercial account, a distributor may retain an exclusive right to his customer in the same manner except that the exclusive right shall be effective for a period of 90 days. [31]

If the 30 or 90-day exclusive period is permitted to expire because of a failure to make and register a sale, then the next distributor to complete a sale and register the customer thereby establishes a new exclusive right period during which such exclusive right shall remain in effect in accordance with the terms outlined above.

Whenever a distributor approaches a new prospective customer, he shall ask whether that prospective customer is presently being sold regularly by an Amway distributor. If the customer is being sold regularly, then the distributor shall make no further attempt to sell that customer, but shall refer the customer to his or her regular distributor. (Emphasis in original.)

This rule was carried over to Amway from the Nutrilite sales plan. (Van Andel, Tr. 2047–48)

91. The Amway Sales and Marketing Plan formerly provided

that a distributor had an exclusive right to sponsor his own customer as a distributor. (CX 60-Z-5)

92. In January 1972, effective March 1, 1972, Amway abolished the "customer protection" rule and the rule giving a distributor the exclusive right to sponsor his customer as a distributor. (CX 284; CX 293)

93. Amway continues to support the principle of the customer protection rule. In June of 1974, Mr. Halliday, one of the three top officials at Amway, spoke at a New Direct Distributors' meeting. He pointed out that, while legal, it was unethical to "go in cutting out another Amway distributor" by taking his commercial account: "[S]ometimes there's a—something above and beyond the law that you have to think about in terms of ethics." (CX 1041-I) [32]

Advertising Regulation

94. Only Amway Direct Distributors are permitted to display the Amway name on the exterior of their distributor office, and that office must be for wholesale only. (RX 331, p. 20-B)

95. Amway controls the display of the Amway name and logo on distributors' business vehicles by approving their use only if the distributor meets specific instructions involving the display of the Amway trademark, trade name, logo, design or symbol, and the condition of the vehicle. (RX 331, p. 21-B)

96. Amway restricts the use by distributors of the Amway name in telephone directories. For example, only Direct Distributors may appear under the Amway or Nutrilite names in the white pages. Other Amway distributors are allowed to use the designation "Amway Distributor" in the white pages, as long as they are listed under their surname. (RX 331, pp. 21-B - 22-B) In the yellow pages, upon prior written approval by Amway, a distributor may list under three specified categories, ("cleaning products," "cosmetics," and/or "vitamins") using the designation "Amway Home Products Distributors." (RX 331, p. 22-B)

97. Only upon prior Amway written approval, may distributors use outdoor advertising on billboards or signs. (RX 331, p. 23-B)

98. Amway distributors may not use the Amway trade name or logo on checks except to describe themselves as Amway distributors. (RX 331, p. 23-B) [33]

99. Direct Distributors may contract for local advertising of Amway products on radio, television, or in newspapers only by using advertising mats and scripts obtained from Amway. (RX 331, p. 23-B)

100. If Amway distributors use the Amway name in classified

recruiting advertisements, the advertisements must follow the exact, word-for-word copy of one of seventeen formats provided by Amway. For example: "Local Amway Distributor is helping many persons earn money working two to four hours a day. We can help you. For interview, call ——————." (RX 331, p. 24-B)

101. All Amway printed material is copyrighted and may not be reproduced by distributors without permission. (RX 331, p. 24-B)

102. Amway restricts the advertising of its distributors in order to keep a consistent market position, among other reasons. (Cady, Tr. 5815)

103. People inexperienced in direct sales tend to overestimate the effectiveness of advertising which may increase their expenses and hasten their exit from the market. (Cady, Tr. 5813-15) The Amway direct sales system is based on the plan that personal contact is more effective than advertising in selling Amway products and recruiting distributors. (Van Andel, Tr. 1857-58)

104. By its regulation of distributors' advertising, Amway attempts to assure that its marketing plan is explained and represented by experienced distributors. (Halliday, Tr. 6244-46; CX 960) [34]

105. With the high turnover rate typical of direct sales organizations, Amway attempts to control the distributors' advertising in order to avoid the negative impact on consumers responding to ads placed by distributors who have gone out of business. (Halliday, Tr. 6244-46; Cady, Tr. 5812-16)

106. Amway uses and has registered 125 trademarks and servicemarks. (RX 336)

107. Amway has controlled the use of its trademarks, servicemarks, and trade names in order to prevent misrepresentations by some distributors. One distributor in Alton, Illinois, ran recruiting ads implying that he was offering employment. A similar incident occurred in New York City. Amway terminated both distributors. (Halliday, Tr. 6246-49) Some Amway distributors in Kansas City falsely represented that Amway cookware was the same as cookware costing twice as much. Amway took disciplinary action against the distributors. (Halliday, Tr. 6253-54) A distributor in Arkansas produced cassette tapes and literature which misrepresented the Amway Sales and Marketing Plan and Amway products. Amway brought suit and injunctive relief was obtained prohibiting the production and distribution of the materials. (Halliday, Tr. 6254-56) Several distributors in Minnesota produced their own literature advertising several Amway cleaning products including a germicide The literature did not give the proper instructions. Relying on the brochure, a distributor recommended to the owner of a goat farm

that the product could be used to sanitize a goat before milking. The literature failed to give proper instructions, and the goatman applied the germicide at full strength and burned several goats severely. Amway located and destroyed all copies of the unauthorized literature. (Halliday, Tr. 6250-51) [35]

108. Amway also controls the use of its trademarks, servicemarks and trade names to avoid possible liability for the contents of advertising by the distributors. (Van Andel, Tr. 2055) Improper use of its logo on vehicles operated by distributors might imply an employment relationship attaching liability in the event those vehicles are involved in an accident. (Halliday, Tr. 6252-53)

Price Fixing

109. Amway has fixed the prices at which its products are to be sold to distributors and to consumers. One of the "Rules of Conduct" of the Amway Sales Plan published in 1963 was that (CX 53-Z-31):

> No distributor shall sell products sold under the Amway label for less than the specified retail price, when making sales to persons who are not distributors, except where commercial discounts are authorized to be given. No distributor shall give a greater discount than that authorized in the appropriate Amway Product Sales Manual.

Those who signed the application to become Amway distributors at that time agreed to comply with those distributor requirements and "to observe the spirit as well as the letter of the Code of Ethics and Rules of Conduct of Amway Distributors." (CX 53-Z-62) Amway had 30,000 distributors in 1963. (CX 53-H)

110. Amway fixed the charge for freight to be collected by the distributors. In 1963, Amway sold its products to distributors FOB regional warehouse. Amway provided that, since the Direct Distributor picked up the products from the warehouse and incurred freight costs in delivering the products to the ordering distributor: "[The Direct Distributor] may assess a freight charge of 1% of [purchase volume] of each invoice to [36] help offset some of this cost. Each sponsor is authorized to pass this charge down the line . . . ." (CX 53-Z-37 - 38) In a few areas that were long distances from the nearest warehouse, Amway's policy was that "it is permissible to add certain additional freight costs to the retail prices, and to increase retail prices." (CX 53-Z-40)

111. Amway still indicates the price that distributors are to charge at wholesale. The 1963 Amway Sales Plan explained wholesale prices (the prices paid in sales from one distributor to another) (CX 53-Z-15):

When a sponsor buys Amway products from his sponsor or Direct Distributor, and resells them to a distributor whom he sponsors, he both buys and sells at the basic discount. Thus products sold between distributors are always sold at the same price, with no profit made on the immediate transaction. The profit is made later on the refund percentage . . . .

(*See also* CX 88-E - 1968) The 1975 Amway Career Manual for distributors explained wholesale prices (RX 331, p. 3-B):

In Amway, a sponsor does not succeed unless his sponsored distributors succeed. He cannot make money by simply selling products to his sponsored distributors because he sells them for the same price he paid for them: the distributor cost. Instead he makes money on the Performance Bonuses they generate on their Business Volume, which in turn is based on their retail sales. . . . [37]

112. Respondents have fixed the prices at which its products may be sold through fund raising drives.

(a) In the Career Manual for Amway distributors published in 1968, Amway specified the products that distributors could sell through fund-raising drives by schools, churches and clubs, and stated that the distributor should (CX 57-Z-152):

See that standard retail prices are observed. Do not permit cut-rate selling. Cut-rate selling during a fund-raising campaign could hurt your own regular selling of these items.

(*Also see* CX 54-Z-128 - for 1965.)

(b) In the Rules of Conduct published November 1, 1969, Amway stated that the Amway Fund-Raising Plan was that (CX 277-"N"):

The selling organization will buy the products from the distributor at retail and will sell them at retail. Selling organizations will be requested to adhere to the suggested retail prices.

The Amway Plan also specified that (*ibid.*): "The distributor will pay the selling organization a *profit* of not more than *the difference between the retail price and the distributor cost* . . . ." (Emphasis in original.) This part of the rule fixing the amount to be paid to the selling organization by the distributor was recommended by the ADA. (CX 338-B)

(c) The current Amway Rule of Conduct for fund-raising drives specifies the six products which may be sold and states that (RX 3[illegible] p. 15-B):

Members of the selling organization will only take orders for the products. S[illegible] orders will be turned over to the sponsoring distributor, and he, or distributors i[illegible] organization, will deliver the products to the customer and collect the purchase p[illegible] [38]

113. The 1965 price list for distributors specified the "retail" price for Amway products. (CX 587) The 1970 price lists specified the the "retail prices (for sales tax purposes)." (CX 593; CX 615) Amway price lists since 1972 have specified "suggested retail for sales tax" (CX 597 - 1972; CX 620 - 1973), or "retail sales comp. base" (CX 598 - 1973; CX 605 - 1976). The current order form states that the price of the Amway products is "suggested retail." (RX 456, RX 460)

114. Amway has a policy of advising distributors not to sell Amway products at discount to commercial accounts. Amway sells training and motivational cassette tapes to distributors for use at sales meetings. Among the "proven ideas from successful distributors" spoken on the tapes is the advice not to grant discounts (CX 1031-I - Transcript of tape sold in 1976, CX 605-M):

> (Don Mumford speaking) So, so anyway, he says, "Don, do you, what kind of a deal do you give? If we order 50 barrels from you, what type of a deal do you give?" They have the same philosophy as Amway. Whether if you buy one case or a thousand cases, it's all the same price. There's no deals. That's what I told him. We don't have any deals. It's all the same price. If it's worth $95 a drum, then 50 drums is still worth $95. I, I'm just telling you this, don't give deals. I don't, it's just not worth it, it's just not worth it. (applause) But anyway, he gave me a blanket order for 50 barrels.

Commercial sales are where price competition among Amway Distributors is most likely to occur. (Halliday, CX 1040-K; CX 485) [39]

115. Amway threatens termination of the distributorship to discourage retail price cutting. In Dallas, Texas, in 1971, Mr. DeVos talked to Direct Distributors and was asked what could be done about price cutting by distributors (CX 1037-E - G):

> Question:] Are you as Amway going to do anything to distributors who are selling roducts at wholesale to retail customers? [DeVos:] If you have a distributor who is elling Amway products at wholesale to a customer, our action has got to be first of all get a complaint on it and find out who the distributor is that's doing it. Our next ove has got to be to work on his removal, but this isn't an easy problem, because if is person wishes to sell to anybody on the street at whatever price he wants to, 're getting into some touchy areas on price fixing. Now the only thing you can nt out is that sooner or later the distributor is going to go broke — because you 't go on selling the product at what you paid for it and survive in the business. . . .

DeVos gave the Direct Distributors further advice on how to to the price cutting distributor. After warning the Direct ributors that price fixing is a serious matter "that the federal le and the FTC watch like a hawk" (CX 1037-G):

> do a sales job on the guy and pointing out that if he's going to continue that he's to destroy his own business, he's gonna work at a non-profit situation, he'll tely not be able to recruit distributors, because they can't make any money and

what he's doing is destroying himself, and therefore in most cases where you have it happen it disappears quite rapidly.

[40] 116. Amway combines with distributors who report price cutting and with Direct Distributors so that pressure may be applied to stop distributors who are retailing Amway products at less than the suggested price. In a tape recording of a new Direct Distributor seminar conducted in 1971, by Mr. Halliday, an official of Amway, and one of the three members of the Board of Directors of the company, told the distributors that, in the event that another distributor sells products at a reduced price, they should approach that distributor's Direct Distributor (CX 1040-J):

[Question:] We have had some people who would, uh, sell products at a reduced price, for example, last week we had a fair booth and, um, I knew some of this was going on, once in a while people would come up and I'd just ask them, I'd say, "Say, what, uh, what are you selling shoe spray for in your area?" And, some of the prices that I got were, uh, very staggering to the imagination. What can we do about this?

[Halliday:] Well, again, I think the only thing you can do about it as an individual is to go to talk to the Direct Distributor of that organization, explain to him what he's doing, as far as the image of all Amway distributors, uh, the fact that they're confusing customers — the potential customers, that the reason that the price — you have to get that retail price is if you're rendering the service that you're rendering that's the only way that you're going to be adequately compensated for it. You're gonna have to work with him on an informal basis. As far as our being able to write him and saying "You can't do it." we cannot.

[41] *See also* the testimony of Lawrence Lemier, an Amway Area Coordinator until October of 1973, who had handled complaints from distributors. Occasionally, a distributor would complain that some other distributor was selling products at less than retail price to retail customers. Mr. Lemier would tell both the Direct Distributor of the complaining distributor and the Direct Distributor of the price cutter that (Lemier, Tr. 179):

[T]here was not much Amway could do in a case like that. We couldn't control prices, but I would let them know that studies were made and that products at the retail, the suggested retail price, those were fair prices to the retail customer and a fair margir of profit to the distributor.

117. This record contains examples of the success of Amway' policy of combination and communication to stop price cutting. I 1972, Lorraine Cooke, an Amway distributor from Gun Lak Michigan, distributed flyers featuring Amway products at bel suggested retail prices. Other distributors reported this to Amw and Lorraine Cooke received the following letter dated June 8, 19 from Ann Penrose, an Amway Administrative Legal Assistant (831-A - C):

Amway Corporation will not tolerate the use of the Amway name, logo, or its products in any manner in privately developed promotional literature. We, therefore, must instruct you to immediately cease and desist the dissemination of both flyers and to destroy any remaining quantities which you may have in your possession.

* * * * * * *

One of your flyers also indicates that you are apparently selling Amway products at a price below Amway's suggested retail prices in a "package special." [42]

As you will note from the SA-13 Wholesale Price List, Amway publishes a suggested retail price list for sales tax purposes. Amway, however, cannot impose a fixed price schedule upon its distributors. Under the Amway Sales and Marketing Plan, each Amway distributor is an independent businessman who purchases products from Amway for cash. Title to these products actually passes from the company to the distributor (and later from distributor to distributor or from distributor to retail customer) under a purchase and sales agreement. At each sale, title passes to the buyer immediately upon purchase. Thus, in essence, each buyer has latitude in determining what price he will charge for the product when he subsequently sells the same.

There are certain built in features about the Amway Sales and Marketing Plan which tend to discourage unreasonable and unrealistic price variances. Perhaps the most important of these is that any price reduction results in less net income to the distributor. The product line manufactured by Amway Corporation is relatively stable, with several new products being added each year, and several products being removed from the line. Generally speaking, the product line remains essentially constant, particularly compared with some other direct selling companies, such as Avon, which have a calculated policy of conducting "sales" every several weeks in order to generate consumer interest and which ties into their constantly changing line of products and packaging.

A policy of "sales" is not consistent with a stable product line, since customers would become confused concerning why there would be a "sale" one month and not during the next. They would lose confidence in the stability of the distributor with whom they are dealing, at least from the standpoint of individual pricing policies. [43]

Then, again, the Amway products, because of their concentrated nature, and the ıanner in which they perform, compete effectively with other products designed ıbstantially for the same purpose and which are available in retail stores. Because of ır advantageous competitive position, the practice of "sales" is not, and would not be, a similar benefit, or would not produce the same results in increasing volume, as is pected by a grocer or supermarket when it embarks upon the same practice.

We are usually able to point out to a distributor that it is to his financial advantage naximize his profits by selling Amway products at the suggested retail price for s tax purposes. Because of certain intricacies of federal law, and those of some es, it is not possible for Amway Corporation to dictate to independent Amway ibutors the prices at which they should sell an Amway product. It has never been ssary for Amway to take any position such as that for the reason that the vast rity of Amway distributors, which means almost 100% of all Amway distributors, ware of the principle stated in this letter and are thus more than content to realize the greatest maximum profit on their sales of Amway products. Therefore, we would certainly discourage any such "sale."

Lorraine Cooke wrote back to Ann Penrose, stating that she had "complied with all your demands" (CX 1008):

I have always through the course of my lifetime—and in my experience as a Girl Scout Leader—preached and tried to practice Fair Play. . . .I cannot tell you how dreadful this has been to me. I am a new distributor—this has been a good lesson to me. . . .and needless to say, I have CAREFULLY re-read my manual and now understand them (sic) more fully. [44]

If I have hurt anyone, in my ambitions to get started in the Amway world, please advise how I may further correct my mistakes. They were certainly. . . .not intended to hurt, please believe me.[3]

Steven A. Bryant, Amway's Chief Attorney, wrote to Mrs. Cooke shortly afterward, when another distributor alleged that Mrs. Cooke had told customers that the area in which she sold was her "territory." Mr. Bryant warned that because of the complaints [including the price cutting episode] concerning her, Mrs. Cooke was in danger of losing her distributorship. He sent a carbon copy of his letter to Mrs. Cooke's sponsors, requesting that they "educate this distributor as she was causing considerable disturbance in the field." (CX 1017)

118. Amway warns against writing letters to distributors concerning price cutting, to prevent the Federal Trade Commission from obtaining them. (DeVos, CX 1037-G, I)

119. Amway's policy is that distributors who advertise Amway products at discount in the newspaper can have their distributorships terminated. (DeVos, CX 1037-I)

120. One of Amway's Rules of Conduct requires distributors to buy back from a sponsored distributor who is leaving the business any marketable products, literature or sales aids, with a 5% discount for handling. (RX 331, pp. 17-B to 17-C) If the distributors do not buy back the products or promotional material, Amway will. (CX 406-C) [45] There are two reasons for the buy-back policy: (1) to prevent inventory-loading, and (2) to avoid discount sales by distributors who may choose to leave the business. (CX 406-D)

121. An example of the execution of the buy-back rule to stop price cutting involved Russell Bortnem, an airplane pilot who had been an Amway distributor for five years. He had sponsored 20 to 30 distributors and had between 75 and 100 in his organization. (Tr. 684) Since his sponsor had moved away, he was authorized to buy

[3] See also Holdridge, Tr. 781-82 and CX 833 for a similar episode.

directly from Amway and service his distributors from the inventory he kept. He built up too much inventory and Amway would not buy back certain products which had been discontinued or the size of which had been changed. Russell Bortnem and three other distributors placed an ad in the Fort Lauderdale newspaper on October 26, 1975, advertising Amway products "Below Wholesale! 'Our loss, your gain'." Mr. Bortnem testified (Tr. 689):

Q. You placed the ad approximately in October, '75, October 26, '75?

A. Yes. I think it ran probably three days throughout a week or a week and a half period.

Q. Did you receive any response from that ad, you personally?

A. Yes. We sold quite a few things but also most of the response was from other direct distributors in the Fort Lauderdale area.

Q. What did direct distributors respond?

A. They were threatening us that, "You can't do this and we are going the [sic] report you to Amway," and everything. . . .

[46] In a few days he received a call from an Amway employee who asked him to remove the ad from the paper and who agreed to buy the inventory. (CX 1049, CX 1050) Mr. Bortnem had indicated previously that he would resign his Amway distributorship if that was what was required to be able to return the Amway products (RX 10). The buy-back agreement prepared by Amway provided that in return for the reimbursement, Mr. Bortnem agreed to relinquish his Amway distributorship. (CX 1050)

122. Amway urges distributors to buy back products even if the products are no longer marketable so that they will not be sold at discount. (Halliday, CX 1040-N, CX 1042-D – E)

123. Amway instructs its distributors that when Amway products are in the possession of shipping companies, salvage stores or freight recovery stores, which acquired the products by paying off insurance claims on damaged freight, the distributor should repurchase the products or notify Amway so that Amway can repurchase them. The reason for this policy is to prevent salvage stores from discounting the products. (CPF 227)

124. Amway collects retail sales taxes at the time of sale to Amway Direct Distributors and pays the state governments. This system was started at the request of state taxing authorities. (Van Andel, Tr. 1782–83; Fisher, Tr. 3201–04) Amway refunds the prepaid sales tax to distributors who request refunds because the products were not sold at the suggested retail price. (Van Andel, Tr. 1817; RX

328) Part of these refunds undoubtedly go to distributors who have consumed the products rather than having resold them. (Van Andel, Tr. 1994) [47]

125. On commercial sales, the distributor can buy the products from Amway and resell to the commercial account, or the distributor can request that Amway finance the sale. If the distributor cannot afford to buy the products, he can send the order to Amway, and if Amway decides the commercial account has a satisfactory credit rating the products will be shipped directly to the customer; Amway will bill the customer and when payment is received the distributor will receive compensation less 3% for this billing and service. Until at least 1972, the Amway instructions for commercial sales to be financed by Amway instructed the distributor to: "3. Indicate price quoted and whether to be shipped prepaid or collect. If freight collect, price quoted should be PV. If freight prepaid, price quoted should be suggested retail . . . ." (CX 61-Z-60)[4] Amway does not currently specify that the purchase price should include freight collect or prepaid. (RX 331, pp. 8-E to 9-E)

126. Amway distributors take title, dominion and risk of loss over Amway products, except for commericial sales where the distributors ask Amway to provide credit. (CX 831)

127. The vast majority of Amway distributors do not cut the retail price for Amway products. (CX 831-B - C) The number of reports annually received by Amway of price cutting by distributors is usually less than a dozen. (Halliday, CX 1040-H; DeVos, CX 1037-D) [48]

Misrepresentations and Failure To Disclose

128. Amway instructs its distributors to make "only such claims as are sanctioned in official Amway literature." (RX 331, p. 14-B) Amway disciplines, by termination or censure, distributors who misrepresent the Amway Sales and Marketing Plan. (Halliday, Tr. 6262-65, 6488-97; Van Andel, Tr. 1847)

129. Amway literature emphasizes that retail selling is an essential part of the Amway Sales and Marketing Plan and that a distributor cannot succeed merely by sponsoring new distributors. (RX 331, pp. 5-A, 8-D through 10-D)

130. Amway emphasizes that hard work is necessary to succeed as a distributor. Amway tells the distributor:

You have to work to build your business. You have to do the succeeding yourself. Not

[4] "PV" meant purchase volume. (CX 61-T) (See CX 615-C.) Since 1975 this has been called "BV" or "business volume." (Finding 52) (See CX 605-F) The name was changed to avoid confusion with "point value" added in that year. (Finding 51)

us. Not your sponsor. Not your group. You. All we can do is urge you on, support your efforts, ship the products, send the Performance Bonuses.

(RX 331, p. 5–A; see also pp. 3–A, 8–D, 9–D; DeVos, CX 1045–G - 1970; Van Andel, CX 999–J; CX 85–X)

131. Amway literature currently states that distributors should not "quote dollar incomes on specific individuals even though you may want to use their stories about the homes in which they live, the cars they drive, or the airplanes they fly." (RX 331, p. 9–D) [49]

132. Amway representatives have stated specific dollar incomes which may be possible to achieve as an Amway distributor. For example, Mr. DeVos attended an Amway rally in Mobile, Alabama, on February 8, 1973, and in a sales inspirational speech stated that the distributors have "unlimited income potential" because how much they made depended on how much they sold and that:

. . .[Y]ou can start out by trying to make $50 and when you start climbing and working with the plan you can make $100,000 in the same plan. (CX 1007–N)

And, he said:

You ought to open up your mind right now to thinking in terms of making $100,000 a year because you can do it and you ought to think that way. (applause) Listen—That won't happen tomorrow, and it won't happen the next day. But if [you] were to work at any other job you've got 40 years ahead of you. And there are going to be people in this room and in this country who by the time they are 40 starting even part time building gradually, they're going to arrive at a point where they are going to have that kind of income only because you dared think about it. (CX 1007–O)

This statement, in context, meant that only some hard workers would achieve this level of success. It was directed to the "young people in their twenties" in the audience. The story preceding it was of a distributor who was finally able to buy her children a new pair of shoes for school. And Mr. Devos said "there aren't many hundred thousand dollar deals in real estate either." (CX 1007–H) [50]

133. Some Amway distributors do make substantial gross incomes from their Amway business. In fiscal 1971, there were 291 Amway distributors who had a purchase volume of $100,000 or more. About 11% of the Direct Distributors in the years 1972–74 did that well. A few sell $300,000 or more. About 28% of the Direct Distributors have an annual purchase volume of $50,000 or more. (CX 917–A - B) In 1974, about 39% of the Direct Distributors received performance bonuses of $10,000 or more. (CX 918–A - B) Well balanced distributors, according to Amway, keep about one-half of the performance bonus. (RX 401, p. 10) In 1974, about twenty distributors received 3% Direct Distributor bonuses of more than

$20,000, ten received more than $30,000, three received more than $40,000 and one got $56,178.92. (CPF 524) (See RX 401, p. 10.)

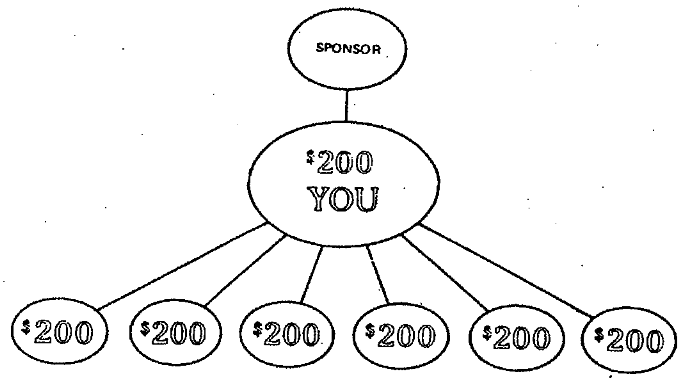
134. Until 1973, Amway explained to new distributors the potential income from retail selling by the representation that (CX 85-T): "By making just one average sale of $5.00 per day, you can sell $100.00 worth of products a month." Later Amway increased the distributors' potential "average gross income" to $200 a month. (RX 331, p. 3-D):

> You can make retail sales that will average $200 BV every month by making "Two sales a day, the Amway Way!" On your $200 in BV, you receive an immediate income of about 30% or $60. (You buy Amway products from your sponsor at varying discounts from 15% to 35%; this averages out at about 30%.) The term "Business Volume" (or BV for short) is used to describe the amount of products that you purchase from your sponsor for your personal customer needs, your own use, and that of the distributors whom you personally sponsor.
>
> You also receive a second income, or a Performance Bonus on your Business Volume (BV), when you have a monthly Point Value of at least 100 points. On $200 BV, your Performance Bonus is 3%, or $6, provided you have Point Value of at least 100 points that month. This means your gross income for the month is $66—a good part-time income for making two sales a day, the Amway way. [51]
>
> ON YOUR $200 IN BV
>
> YOUR AVERAGE GROSS
>
> INCOME IS
>
> $60.00
>
> YOU ALSO RECEIVE A
>
> PERFORMANCE BONUS OF 3% OF $200 BV
>
> OR
>
> $6.00
>
> TOTAL GROSS INCOME
>
> FROM YOUR OWN RETAIL
>
> BUSINESS IS
>
> $66.00

135. Amway instructs its distributors to explain the potential income to be made by sponsoring by "drawing circles." These diagrams are based on Amway's representations that a distributor's potential "average gross income" is a particular amount. Until 1973, Amway used $100 for the amount. (CX 61-Z-31 to Z-35) By 1975,

Amway had increased that amount to $200 BV (RX 331, p. 5-D through 7-D): [52]

FOR DISCUSSION PURPOSES, LET'S ROUND OUT THE NUMBERS TO $200.00. I'M SURE YOU REALIZE THAT SOME WILL DO MUCH LESS AND SOME MORE. BUT, IF THEY MAKE TWO SALES A DAY, THEY SHOULD SELL AT LEAST $200 (AT BV) PER MONTH.

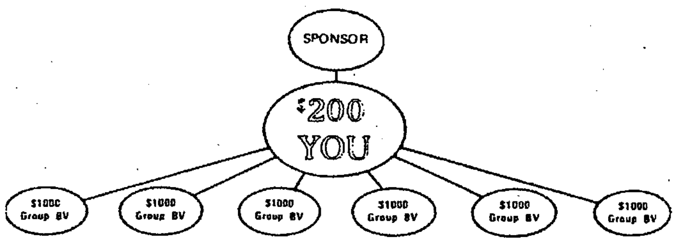


Immediate income on Personal Sales of $200 (at BV)		$ 60.00
Your total Group BV:		
$200 in BV x 7	$1400	
12% Performance Bonus on $1400 (assuming Point Value of at least 1,000 points)	$ 168	
Less Six 3% Performance Bonuses on $200 to your distributors (assuming necessary Point Values have been achieved by each distributor)	– $ 36 Performance Bonus you pay	
	$ 132 Performance Bonus you keep	$132.00
Total gross income from your business		$192.00

5-D

YOUR BUSINESS CAN BUILD EVEN LARGER AS YOU TRAIN AND INSPIRE YOUR PERSONALLY SPONSORED DISTRIBUTORS TO DUPLICATE THEMSELVES BY SPONSORING NEW DISTRIBUTORS. LET'S SAY THAT SIX OF YOUR PERSONALLY SPONSORED DISTRIBUTORS SPONSOR FOUR DISTRIBUTORS EACH AND THAT EVERYONE MAKES TWO SALES A DAY, WITH EACH ONE SELLING $200 (AT BV) A MONTH.

YOUR INCOME PICTURE FOR THE MONTH WOULD LOOK LIKE THIS: (HERE AGAIN FOR THE SAKE OF SIMPLICITY, WE HAVE ROUNDED OUT THE NUMBERS TO $200.)

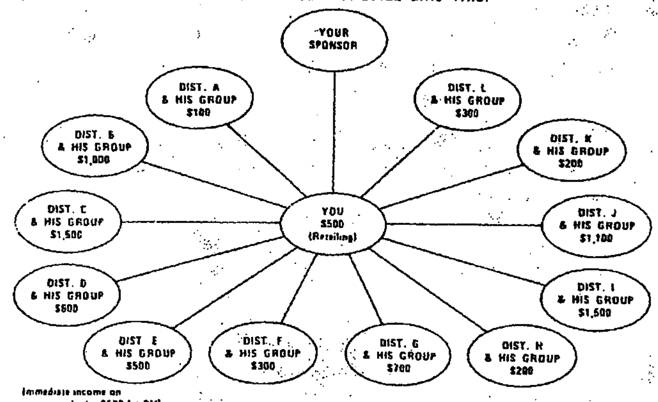


Immediate income on personal sales of $200 BV		$ 60.00
Your total Group BV:		
$200 in BV x 31 or 6 groups of 5 distributors plus your own sales	$6,200	
23% Performance Bonus on $6,200 (assuming Point Value of at least 6,000 points)	$1,426	
Less six 12% Performance Bonuses on $1000 to your distributors (assuming necessary Point Values have been achieved by each distributor) who in turn pay Performance Bonuses to their distributors	−$ 720 Performance Bonus you pay	
	$ 706 Performance Bonus you keep	$706.00
Total gross income from your business		$766.00

THE GROWTH OF YOUR PART-TIME BUSINESS FROM THIS POINT ONWARD CAN ONLY BE DESCRIBED BY THE PHRASE – IT EXPANDS RAPIDLY. THE OPPORTUNITY IS THERE FOR YOU TO CONTINUE TO BUILD YOUR SALES ORGANIZATION IN THE SAME WAY UNTIL YOU ATTAIN A MONTHLY POINT VALUE OF 7,500 OR MORE POINTS. IT WILL, OF COURSE, REQUIRE MORE TIME AND MORE EFFORT, BUT IT CAN BE DONE AS A PART-TIME BUSINESS.

THE DISTRIBUTORS SPONSORED BY YOUR PERSONALLY SPONSORED DISTRIBUTORS SPONSOR OTHER DISTRIBUTORS, AND THUS YOUR GROWTH EXPANDS EVEN MORE.

A DIRECT DISTRIBUTORSHIP CAN HAVE A PROFILE LIKE THIS:



Immediate income on personal sales $500 (at BV)			$ 150.00
Your total group BV	$8,500		
Performance Bonus you receive (25%, assuming Point Value of at least 7,500 points)		$2,125.00	
Performance Bonuses you pay out (assuming necessary Point Values have been achieved by each distributor)			
Distributor A (3%)	$ 3.00		
B (12%)	120.00		
C (15%)	225.00		
D (9%)	54.00		
E (6%)	30.00		
F (6%)	18.00		
G (9%)	63.00		
H (3%)	6.00		
I (15%)	225.00		
J (12%)	132.00		
K (3%)	6.00		
L (6%)	18.00		
TOTAL PAID OUT		– $ 900.00	
		$1,225.00	
(Distributors A, B, C, D, E, F, G, H, I, J, K, and L will, of course, be responsible for paying Performance Bonuses to their distributors.)			
Performance Bonus you keep:			$1,225.00
Total monthly gross income			$1,375.00

7-D

[55] Amway distributors use this technique in recruiting new distributors. (Yager, CX 1040-U; Trozera, CX 1031-E; Cliett, Tr. 3758-59) In 1977, Amway raised the basic amount to be used in the circles to $250. (RX 401, pp. 7-8)

136. In speaking to a new Direct Distributors meeting in June of 1974, Mr. Van Andel explained the reasons for specifying a particular sum to represent the amount of the distributors' sales in the circles drawn to show the plan (CX 1041-T):

> What is my personal opinion with regard to the $200 circles versus the $100 circles? Well, we think that the $200 circle concept raises the, the vision of people, and we have found through experience, as you have I'm sure, that people tend to do that which you ask them to do. If you had $50 circles, they'd probably do $50. If you have a hundred they do a hundred, and if you do $200 they probably do $200. Now, there's a limit to that, and, er, you know, you can follow that through and say let's make 'em $5,000 circles — well, it doesn't quite work out that way. But I think the general consensus, and we discussed this widely with Direct Distributors, Diamond Direct Distributors, with the ADA Board, was that the $100 figure was too low. And that by raising it to $200, it would result in a general upgrading of the potential of a great many distributors, which would be good for them and good for you. And that's, I think, about the way it's worked out for most people. . . .

137. The average monthly BV of Amway distributors in fiscal 1969-70 was about $20 a month. In fiscal 1973-74 the average BV for each distributor was about $33 a month. (CX 517-F, Z-95) Much of this amount is consumed by the distributors themselves rather than resold. The distributors obtain Amway products with about a 30% discount off the retail price. Many of them consume large amounts of the products every month. (Cook - $75, Tr. 4742; Marshall - $35 to $45, Tr. 4761; Woodworth - $60, Tr. 4787; Wespinter - $75 to $100, Tr. 4884; Rivett - $60, Tr. 4971; Nieman - $75 to $100, Tr. 5081; Hendrickson - $150, Tr. 5181; Gregory - $40, Tr. 5209; Williams, $125-$150, Tr. 5325; Evans - [56] $70-$80, Tr. 5300-01; Wakeman - $30-$40, Tr. 5446; Burgess - $25-$40, Tr. 5460; DeJean - $30-$40, Tr. 5501; Wong - $80-$100, Tr. 5650; Wolfe - $100, Tr. 5664)

138. Amway instructs new distributors to recruit additional distributors by the following method. After making a list of friends, relatives and neighbors, the new distributor is instructed (RX 331, p. 1-D):

> Give these friends, relatives and neighbors the benefit of a full presentation of the Amway Sales and Marketing Plan. Don't try to explain over the phone. Encourage them to attend the meeting by telling them that this is an opportunity to be in business for themselves on a part time basis with no investment in inventory necessary. Tell them they may build a business earning as much as $1000 or more a month. Mention that you have started your own independent business on a part time basis and that you would like to tell them about it.

Amway distributors use this technique in recruiting new distributors. (Dirksen, Tr. 423; Holdridge, Tr. 743, 819; Bernard, Tr. 1364–65, 1376–77; Johnson, Tr. 1439; Rovena, Tr. 1633–34; Blinko, CX 1041–Y; Johnson, CX 1115–B; Williams, CX 990–Z–30; Eldridge, CX 999–V)

139. Amway recruiting literature used in 1964 stated that: "Sponsoring is easy!" The 29 page single spaced manual continued, however, to outline the method used in sponsoring, referring to several other Amway manuals, and concluding: "After your first reading this manual may seem a bit confusing to you. If (sic) may seem like there are a tremendous number of things to remember and learn. Don't try to remember all the details now. Start with the first step . . . ." (CX 89) (1964) More recent recruiting literature is even more detailed. (CX 91) (1975) [57]

140. Amway literature explaining the Sales and Marketing Plan cautions that distributors incur expenses in the operation of the distributorship, such as automobile, telephone, stationery, literature, utility and other operating expenses. (CX 88, p. 10, RX 401, p. 10, CX 87, CX 62–Z–18, CX 60–Z–19, CX 61–Z–18, CX 91–H, CX 1096, pp. 2–H and 3–H, CX 793, p. 10) Distributors are also told at meetings to watch expenses. (DeVos, CX 1045–B)

141. Amway has warned its distributors that it is realistic to expect a new distributor to drop out in only one week. (CPF 505) In 1970, Mr. DeVos told new Direct Distributors that "about half the people who sign up the first time sign up the second year." (CX 1045–B) Amway teaches its distributors to expect newly sponsored distributors to quit the business and to be prepared for the let down. (CX 1000–W) [58]

Pyramid Sales

142. "Pyramid" sales plans involve compensation for recruiting regardless of consumer sales. In such schemes, participants receive rewards for recruiting in the form of "headhunting fees" or commissions on mandatory inventory purchases by the recruits known as "inventory loading." (Van Andel, Tr. 1820–21; Patty, Tr. 3147, 3091–92; Cady, Tr. 5778–79)

143. "Pyramid" sales plans based on inventory loading or headhunting fees create an incentive for recruiting rather than selling products to consumers. This potentially results in the number of recruits outgrowing the market for products being sold to consumers. (Granfield, Tr. 2996–97)

144. The Amway Sales and Marketing Plan provides incentives for sponsoring which are based on sales of products to consumers.

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(Van Andel, Tr. 1823–24; Granfield, Tr. 2951–52; Patty, Tr. 3092–95; Cady, Tr. 5779–81; Max, Tr. 5995–97) It is not a pyramid sales plan.

145. Amway's buy-back rule deters inventory loading by sponsoring distributors. (Van Andel, Tr. 1999–2000; Halliday, Tr. 6231–32; S. Bryant, Tr. 4062–63)

146. Amway's 70% rule deters inventory loading by sponsoring distributors. (Cady, Tr. 5795–97; Halliday, Tr. 6231; Lemier, Tr. 176)

147. Amway's ten customer rule deters inventory loading by sponsoring distributors. (Max, Tr. 5996–97) [59]

Saturation

148. Distributors have come into the Amway business in the United States as follows (RX 381):

Year	*New Distributors*
1972	255,000
1973	231,000
1974	213,000
1975	237,000
1976	280,000

Each Amway distributor who wants to continue as an authorized Amway distributor (except those recruited after August 31 of that year) must notify Amway. At the end of the calendar year the files are cleared of the names of distributors who elected not to continue. The number of distributors at the beginning of the year therefore is close to the number of active distributors. (Halliday, Tr. 6483–87) The turnover rate for all Amway distributors (including international) is as follows (RX 383):

Year	*Number at the End of Prior Year*	*Number at beginning of Year*	*Turnover*
1972	646,633	320,738	50.4%
1973	655,310	306,002	53.3%
1974	546,328	298,561	45.4%
1975	518,583	294,328	43.2%
1976	549,516	315,187	42.6%
1977	610,059	359,470	41%

149. Amway distributors from various parts of the country gave credible testimony that they have found that in recent years it has become easier to sponsor new distributors. (Hansen - Grand Rapids, Michigan, Tr. 3271–72; Cliett - Fairfax Station, Va., Tr. 3747; Zizic - Timonium, Maryland, Tr. 4113–14; Hunt - Holly Pond, Alabama, Tr. 4412; Wespinter - Portage, Michigan, Tr. 4883–84; Evans - Wray,

Colorado, Tr. 5263–64; Lamb - Missoula, Montana, Tr. 5607; Case - Phoenix, Arizona, Tr. 3401–02) [60]

150. The Amway Sales and Marketing Plan, not being a "pyramid" plan, has not led to any significant difficulty in recruiting new distributors.

a. Some witnesses, called in support of the complaint, testified to their difficulty in sponsoring new distributors in their areas of the country. Other evidence, however shows that the opportunity to sponsor new Amway distributors has continued in those areas:

Baton Rouge, Louisiana - The new distributors increased from 332 in 1975 to 547 in 1976. (RX 372) The population increased 45,000 from 1970 to 1976. (RX 354)

Charlotte, North Carolina - The new distributors increased from 688 in 1975 to 1014 in 1976. (RX 375) The population increased 65,000 from 1970 to 1976. (RX 357)

Conway, South Carolina - The time period for which there was testimony about difficulty in sponsoring (1973–1976) shows a slight drop in new distributors in 1973 from 326 to 307 in 1976; the total number of distributors increased from 536 in 1973 to 678 in 1976. (RX 376) The population increased 22,000 from 1970 to 1976. (RX 358)

Florida counties - Although the total number of distributors has declined from 1971 through 1976, there have been an average of over 2,000 new distributors added each year during this time. (CX 898–A, RX 378, RX 379, RX 380) The population has increased 620,000 from 1970 to 1976. (RX 361–63)

Dallas/Ft. Worth, Texas - Although there was a 64% decrease in the number of new distributors recruited from 1971 to 1973, the number increased by 56% from 1973 to 1976. (RX 377) The population increased 175,000 from 1970 to 1976. (RX 359) [61]

Kalamazoo, Michigan - The population increased 13,000 from 1970 to 1976 (RX 355) and there were an average of 775 new distributors in each year from 1972 to 1976. (RX 373)

b. Other witnesses whom I heard and find credible were called by respondents and testified that in several of these areas they had no difficulty sponsoring new distributors during the relevant time. (Rivett - Baton Rouge, Tr. 4943–44; Gregory - Dallas/Ft. Worth, Tr. 5200–01; Wespinter - Kalamazoo, Tr. 4882–84; Brown - Florida counties, Tr. 4997–5001)

151. It is relatively unlikely that the available supply of potential Amway distributors will be exhausted in any particular area. It is predominently a part-time activity. The population of the country continues to grow. Former Amway distributors sometimes come back in the business. (Max, Tr. 5950–52; RX 381) Twenty-five percent of the population move every year. (Van Andel, Tr. 1829–30, 1916) Only one-fourth of all Amway distributors engage in sponsoring (Van Andel, Tr. 1828–30), and there has been no decline in the percentage of Amway distributors who sponsor over the last five or six years. (Max, Tr. 5958–59, 5965–69; RX 415) Amway's sales trend has shown almost uninterrupted growth (RX 448) in each state as well as nationally. (RX 432) Average monthly income for Amway distributors has been increasing. (Cady, Tr. 5818) Average sales per distributor have been increasing. (Max, Tr. 5965–69) There has been an increase in the number of Direct Distributors. (CX 896)

152. Amway has had a rule against distributors misrepresenting the Amway Sales and Marketing Plan as involving only sponsoring. Amway enforces this rule by terminating distributorships or by censure, impounding bonuses and reorientation. (Halliday, Tr. 6488–97) [62]

Direct Selling

153. Direct selling companies distribute their products through independent salespersons who sell to consumers person-to-person on a commission basis, typically demonstrating the effectiveness of the products in the homes or places of business of the customers. Some direct selling companies are "multi-level," with independent distributors acting as wholesalers as well as retailers. Others are integrated down to the wholesale level, with only the retail sales to consumers being made by independent salespersons. (Van Andel, Tr. 1691–95; Granfield, Tr. 2917–18)

154. There are in the United States more than 2000 companies engaged in direct selling. (Van Andel, Tr. 1812, 1693–95; RX 403) There are about 30 to 40 major direct selling companies in the United States. (Patty, Tr. 3067) Direct selling industry sales annually amount to between ten and fifteen billion dollars, about one or two percent of all retail sales. (Patty, Tr. 3068) This does not include companies selling such products as insurance, real estate, milk or newspapers. (*Ibid.*) Direct selling companies hire about two million people. (Patty, Tr. 3069) Avon is the largest direct selling company with annual sales of $1.25 billion. (Van Andel, Tr. 1693) Many direct selling companies have been acquired by large companies not previously engaged in direct selling. Some of these acquired compa-

nies include Tupperware, Electrolux and Fuller Brush. (Patty, Tr. 3146)

155. Direct selling often starts with the salesperson calling on friends and relatives but to build a business eventually requires calling on strangers. (Patty, Tr. 3088) Door-to-door selling is direct selling by knocking on strangers' doors, although the term has a broader definition meaning direct selling of all types. Amway advises its distributors to sell to friends, relatives, neighbors or persons referred by a customer. This gives the distributor an introduction to the prospect. (Van Andel, Tr. 1757–58) **[63]**

156. Direct selling companies usually sell high quality products, in order to recruit salespersons and to induce homeowners to allow sales persons into the privacy of their homes. The products typically are high priced items such as encyclopedias and vacuum cleaners (where the salesperson can make up for demonstrating lost sales through the high price of products sold) or low priced, frequently purchased items where the salesperson is trying to develop a regular clientele. (Patty, Tr. 3080–81) Some companies sell an expensive high quality line of products through direct sales and a different inexpensive line through retail stores. (Patty, Tr. 3102) One encyclopedia company (World Book) tried selling through a department store but found very few people would pay for the books without personal selling and demonstration afforded by direct selling. (Patty, Tr. 3102–03)

157. Direct selling provides convenience for consumers who have to travel long distances to shop or who may be confined to their homes by age or health or a number of small children. It provides product demonstration not available in retail stores. Direct selling also provides supplemental income for many people working part-time. (Patty, Tr. 3075–77) It also allows the salespersons to be their own bosses. (Patty, Tr. 3090)

158. Direct selling can provide a manufacturer with distribution of a new product without heavy media advertising and promotion costs. (Granfield, Tr. 2944–45; Patty, Tr. 3069–75)

159. Selling through independent distributors avoids fixed costs incurred by selling through employees, such as social security, unemployment compensation and employment salaries. (Granfield, Tr. 2932) **[64]**

160. Successful direct selling usually requires:

(a) Dependable, quality products. (Granfield, Tr. 2950; Patty, Tr. 3083) A quality product makes it easier to recruit distributors. (Cady, Tr. 5765–66);

(b) Money-back guarantee. (Granfield, Tr. 2950) An unconditional guarantee helps recruit distributors by assuring them of the quality of the product and encourages consumers to try a new product. (Cady, Tr. 5769-70);

(c) Ability to recruit, retain, train, and motivate a sales force. (Granfield, Tr. 2938-41; Cady, Tr. 5773-74; Patty, Tr. 3081).

161. Direct selling provides a channel of distribution for a relatively small or new company which has new, good products but does not have the financial resources to sell in traditional retail stores, with the high advertising and other expenditures entailed by that method. Lack of financial strength in such circumstances leads to the small innovative company being acquired by larger companies. (Patty, Tr. 3074)

162. Annual turnover of salespersons for companies engaged in direct selling of lower priced products averages about 100%. (Granfield, Tr. 2942-43; Patty, Tr. 3106) A direct selling company with less than a 60% turnover rate is doing a relatively good job of recruiting and retaining salespeople. (Patty, Tr. 3106-07)

163. Amway's annual turnover rate has usually been in the 50% to 60% range. (RX 383) [65]

164. Because of the relatively high rate of turnover among salespersons, direct selling companies continually recruit new salespersons. (Patty, Tr. 3103-04; Cady, Tr. 5778) Recruiting is essential to a direct selling company. (Patty, Tr. 3103)

165. Some direct selling companies use employees to do most of the recruiting of new salespersons. Independent contractors do the selling, and may be paid a small reward for referring a new recruit. Avon, Electrolux and greeting card companies use this system in the United States, although overseas Avon and Fuller Brush use the same system of recruiting as Amway. (Patty, Tr. 3153; Van Andel, Tr. 1695, 1889; Granfield, Tr. 2959-60)

166. Amway pays about 60% of its sales dollar to distributors in payment for the distribution of Amway products. (Halliday, Tr. 6213-14) Distributors for other direct selling companies do not get paid any more money, if they get as much. (Halliday, Tr. 6191-93)

167. "Multilevel direct selling" refers to a firm which has a number of levels of supervision, which involve independent contractors who are not employees of the company. They are compensated on the basis of margin rather than a commission or salary. Several direct selling companies are multilevel, including most encyclopedia companies. (Patty, Tr. 3130-32; Van Andel, Tr. 1694-95)

168. Some multilevel direct selling companies have engaged in

"pyramid selling," involving "inventory loading" and "headhunting" fees. These companies have a large inventory requirement for a new distributor, and reward distributors for bringing into the business a new distributor. The result emphasizes recruiting of new distributors rather than selling the products to consumers. Typically, these pyramid companies require new recruits to buy $2000 to $5000 in inventory, with as much as half of that amount going to the recruiting distributor. (Patty, Tr. 3091–92) **[66]**

Amway's Product Markets

169. Amway started in the business of manufacturing and distributing soap and detergents, and this still is its primary activity. (Van Andel, Tr. 1680–81) Soap and detergents accounted for more than 40% of Amway's 1974 sales; polishes and sanitation goods accounted for 20%; and toilet preparations accounted for about 7%. (RX 405) Amway's 1974 sales of soap and detergents amounted to $57.9 million, accounting for 1.7% of the total sales of soap and detergents in this country. (RX 404; RX 406)

170. The market for soap and detergents in the United States includes laundry detergent, dishwashing detergent (either of which may be liquid or powder), bar soap, and a small volume of speciality products such as laundry aids and scouring cleansers. (Diassi, Tr. 5517, 5558)

171. The manufacturing and distribution of soap and detergents is highly concentrated, with the largest firm, Procter & Gamble Company, accounting for half the sales. Procter & Gamble, Colgate-Palmolive Company and Lever Brothers account for 82% of industry sales. The fourth largest firm, Purex Corporation, has 4% of sales. (RX 407; Diassi, Tr. 5516–17; Robbins, Tr. 6744) Market shares in the laundry detergent industry, in pounds produced in 1973 and 1975 were (CX 561-G):

	1973 % of Market	*1975 % of Market*
Procter & Gamble		
Tide	26.0	28.0
Cheer	8.5	8.5
Bold	4.5	4.5
ERA		4.5
Six Others	14.0	10.0
Total P & G	53.0	55.5

[67] Lever		
All-Liquid	1.1	1.5
All-Powder	6.5	6.5
Wisk	5.1	6.0
Breeze	2.4	2.4
Three Others	6.9	5.2
Total Lever	22.0	21.6
Colgate		
Fab	5.5	4.8
Cold Power	4.0	4.0
Ajax	3.0	3.0
Dynamo	0.7	2.0
Two Others	2.0	1.9
Total Colgate	15.2	15.7
Others	9.8	7.2
Total	100.0	100.0

Amway's leading product, SA8 Plus, accounted for .78% of this market. (CX 561–F)

172. The personal care products market is also concentrated. The largest firm, Procter & Gamble, has 24% of total sales. The next three, Lever Brothers, Colgate-Palmolive and Gillette, account for 25%. (RX 408)

173. Procter & Gamble Company has been in the soap business since 1837 and had 1976 sales of about $6.5 billion. Colgate-Palmolive Company started in the soap business in 1864 and had 1976 sales of about $3.5 billion. Unilever Ltd., known as "Lever Brothers" in the United States, started in the soap business in 1894 and had 1976 sales of 8.7 billion pounds sterling. (RPF 50) Two other companies manufacture and distribute some of their brands of soap and detergents nationally, Purex Corporation and Church and Dwight Company (using the "Arm & Hammer" label). (Robbins, Tr. 6718–19; Diassi, Tr. 5571–72) [68]

174. Private label soap and detergents are manufactured by a few relatively small companies and are sold by retail stores under their own brand names. Total national private label sales amount to about 5% of the detergent market. (Diassi, Tr. 5519–20, 5548)

175. The three largest manufacturers in the soap and detergents industry spent over a half a billion dollars in advertising and sales promotion in 1975. (RX 410–13) Procter & Gamble, the nation's

largest advertiser, spent over $360 million in product promotion in 1975. (RX 413) Amway spent less than a million dollars in that year for institutional (non-product) advertising. (Teska, Tr. 2751–52; RX 413)

176. Most Amway products are of the kind sold through chain food stores. (Cady, Tr. 5758) Over 95% of the retail sales of soap and detergents in this country is by grocery stores. (Diassi, Tr. 5576; Cady, Tr. 5758) Obtaining retail shelf space is critical for successful entry into the soap and detergents market. (Cox, Tr. 3819) Retail grocery stores are reluctant to add a new product unless it promises to sell quickly. (Diassi, Tr. 5535) The successful marketing of a national brand of detergent through retail stores requires that the product be available in almost every retail outlet where detergents are sold. (Diassi, Tr. 5525–26) Retail grocery chain stores are becoming increasingly concentrated. (RX 449, pp. 9–11)

177. Attempted new entry into the soap and detergents market has faced substantial increased promotional and advertising spending by Procter & Gamble. (Max, Tr. 5930–32; Robbins, Tr. 6728–30; Dunlap, Tr. 6683) Procter & Gamble also counters attempted introduction of a new brand of detergent with introduction of its own new brand. (Robbins, Tr. 6731–32; Cox, Tr. 3854–55) By producing many brands, Procter & Gamble has succeeded in occupying a great deal of grocery shelf space. (Cox, Tr. 3819) [69]

178. The three largest manufacturers of soap and detergents at first resisted the demand for non-phosphate detergents during the early 1970's, brought about by concern with the environmental impact of phosphate detergents. (RX 353) Several companies attempted to make and sell a non-phosphate detergent. (Cox, Tr. 3806–07) Armour & Company, established in 1863 with 1976 sales of $2.7 billion, and an established firm in the bar soap industry, attempted to enter the laundry detergent market with a concentrated non-phosphate product called "Triumph." Despite considerable promotion, the attempt was a failure. (Diassi, Tr. 5527–30) Church & Dwight ("Arm & Hammer") entered the market with a non-phosphate laundry detergent and gained about 4% of the market and was the only successful entrant with a non-phosphate detergent. Church & Dwight is one hundred years old and was already in grocery stores with an established brand of washing soda and baking soda. (Diassi, Tr. 5571–73) Following this entry, and following ecology legislation by several state and local governments, the major soap companies started selling non-phosphate detergents. (Diassi, Tr. 5570)

179. Purex Corporation started manufacturing household bleach in 1927. Purex started manufacturing dishwashing detergent in 1947

and laundry detergent in 1952. Since then, Purex has been able to sell several of its soap and detergent products nationally, using established trademarks gained through acquisition ("Old Dutch Cleanser," "Brillo," "Sweetheart" soap), some national advertising, its own sales force, and prices about 20% below those of the major soap and detergent companies. (Robbins, Tr. 6696, *et seq.*)

180. Los Angeles Soap Company has been marketing soap through retail stores for 116 years, and has been using the "White King" tradename since the turn of the century. It sells regionally in 18 western states, where it has 2% of the market, and prices low enough to allow the grocer to double and sometimes triple the profit he would make selling national brands. (Dunlap, Tr. 6640–42, 6653–54, 6670) In the early 1960's, Los Angeles Soap Company tried to enter the eastern market with a plant at Framingham, Massachusetts. The expansion failed and the plant was sold as scrap. (Dunlap, Tr. 6671–72) [70]

181. Except for the non-phosphate detergents, there has been virtually no new successful entry in the national market for sales of soap and detergents through retail stores in the last thirty years. (Cox, Tr. 3799, 3805; Diassi, Tr. 5523–33; 5571–72; Granfield, Tr. 2936–37; Dunlap, Tr. 6670–72, 6676–77) The market has been increasing at a rate of about 4% a year since 1954. (Cox, Tr. 3807)

182. Amway's laundry detergent sells at retail for slightly more per use than the detergents of the major soap and detergents companies, and slightly less if Amway's large size product is purchased. (Max, Tr. 6038–45) On a cost per use basis, in 1967, SA8 was less than 3¢ and Tide was about 7¢. At this time, SA8 use direction was 5/32 cup per washload and Tide was 1.75 cup. The cost per use drew close in 1968 when the use direction was changed: SA8 1/4 cup and Tide 1.25 cup. In 1972, Tide again changed its use direction to 1 cup per washload, in response to "phosphate down the drain" legislation. (CX 561–Z–11 - 12) Since then SA8 has cost about 1¢ to 2¢ per use more than Tide and the other leading laundry detergents. Sold in the large size (100 lbs.), however, SA8 has a lower per use cost than any laundry detergent. (CX 561–Z–14) In 1973, Amway introduced SA8 Plus, selling at retail for about the same as SA8, but apparently superior in cleaning power to either SA8 or Tide. (CX 561–Z, Z–3 to Z–4) And, unlike detergent purchased at the grocery store, Amway's products are delivered to the consumer's home. (Max, Tr. 6045)

Amway Is a Substantial Industrial Company

183. Amway's United States sales have grown from $4.3 million

in 1963 to $169.1 million in 1976. Worldwide sales of Amway products in 1976 amounted to about $205 million. (RX 431, RX 448) [71]

184. Amway employed over 1,500 persons in 1976 at its plant in Ada, Michigan, with an annual payroll of $19 million. The plant represents a capital investment of $56 million. In 1976, Amway paid over $60 million to its distributors, over $41 million for raw materials, and $11 million to third parties for transportation of Amway products. (RPF 248)

185. All but a few of the regular-line products sold under the Amway name are manufactured by Amway or its subsidiary, Nutrilite Products, Inc. (Van Andel, Tr. 1805) Amway's plant and equipment are modern and efficient. (RX 68 to RX 277) Amway follows recognized industry standards of good manufacturing practice. (RPF 90) It has a substantial research and development operation and expends generally as much per sales dollar as larger competitors in the personal care products field. (RPF 86)

186. Amway's products have very high consumer acceptance. A market study in the record shows that of 37 brands of laundry detergent, Amway's product, with only a very small market share and no national advertising, was third in brand loyalty. (Cady, Tr. 5823) Amway's dishwashing liquid soap led all 16 brands surveyed in consumer acceptance. (Cady, Tr. 5819–22) In each of the markets for automatic dishwasher detergents, detergents for fine clothing, bleaches, rug cleaners, and laundry additives, Amway's products were second in brand loyalty. (Cady, Tr. 5822) Professor Cady, a marketing specialist from the Harvard Graduate School of Business Administration, testified that (Tr. 5823):

> What this means overall is that consumers are obviously well served by the products that Amway supplies them with. In fact, they are so well-served, in the face of a large number of available substitutes, they purchase Amway products to a degree which is almost unknown to other brands in the market.

[72] Amway has achieved this consumer acceptance for its products while having no more than 1.7% of any market in which it competes (RX 406) and while spending a total of about two million dollars for advertising and sales promotion for the years 1972 through 1975, while its top five competitors were spending about 2.3 billion dollars for that purpose. (RX 410 to RX 413)

187. Amway, through its distributors, provides services to consumers not readily available when products are purchased at a retail store. Amway has a 100% money-back guarantee which permits a customer who is not satisfied with an Amway product to return it with the choice of replacement, repair, credit, or refund of full

purchase price (RPF 93, 94, 98) Distributors provide the service of home or commercial delivery at the time convenient to the customer, including weekends and evenings. (RPF 98(a)) Amway ditributors demonstrate and explain product use. (RPF 98(b) and (c)) Distributors perform water hardness tests and recommend the use of a dishwashing detergent for hard or soft water. (RPF 98(d)) Amway and its distributors provide advice for safe product use. (RPF 98(e), 98(i)) Distributors leave sample products with customers for trial use before purchase. (RPF 98(f)) Distributors install Amway products when necessary, such as smoke detectors, and deliver to the laundry room 100 lb. and 85 lb. boxes of detergent. (RPF 98(m)) [73]

Discussion

The following discussion is intended to summarize and supplement the foregoing findings of fact and to present conclusions of law derived from the facts as found.

Summary

Amway was founded in 1959 by Jay Van Andel and Richard M. DeVos, who continue as its principal executives and stockholders. Prior to that time, they sold Nutrilite food supplements door-to-door and headed a large group of distributors. They began having supply problems and started looking for different products to sell. They looked for readily consumable, low-priced, repeat sale products which would be different than those found in retail stores.

Mr. Van Andel and Mr. DeVos started distributing a liquid biodegradable detergent[5] which they named "LOC." A few months later, they acquired the small manufacturer of LOC, moved the assets to Ada, Michigan, and started manufacturing their own products under the Amway label. Amway's second product, also biodegradable, was a powder laundry detergent, SA8. Amway continued to introduce new products and now manufactures and sells more than 150, but its main product market continues to be soap and detergents, accounting for more than 40% of sales. [74]

Amway's principal products are of the kind that are sold in chain food stores. These markets are dominated by a few large manufacturers, of which the largest is Procter & Gamble. Procter & Gamble sells about half of all of the soap and detergents sold in this country, and one-fourth of the personal care products. The three largest firms

[5] Synthetic detergents have largely replaced soap for laundry and dishwashing purposes in the last 30 years, being chemically different and much more effective. (Diassi, Tr. 5573-74) "Biodegradable" means that the ingredients of the detergent are broken down by natural biological action, helping to eliminate foaming problems in lakes and streams. (Halliday, Tr. 6095, 6154)

in the soap and detergents market sell over 80% of total market sales and this dominance existed prior to Amway's origin. *FTC* v. *Procter & Gamble Co.,* 386 U.S. 568, 572–73 (1967). Entry into this market has been blocked for thirty years by the major soap companies by product differentiation achieved through advertising, by retaliatory pricing and promotions, and by brand proliferation.[6]

Amway entered the market with biodegradable detergents. Mr. Halliday, an officer of Amway, was asked (Tr. 6154):

Q. At the time of introduction of LOC and SA-8 by Amway, do you know whether other detergents were then biogradeable [sic]?

A. I know that none of the detergents marketed by the big three soapers were or did contain biodegradeable ingredients at that time.

Q. How long afterward did the detergent industry essentially go biodegradeable?

A. It was up to 10 years afterwards.[7]

[75] Amway marketed its products by selling directly to consumers in their homes through a large number of salespeople. These independent distributors find the customer, and explain, demonstrate and deliver the products. Most of them work part-time. Three out of four quit after the first year.[8]

Some promoters posing as direct selling companies have rewarded recruiting itself in "pyramid" plans, involving "headhunting" and "inventory loading." Recruits earn money by securing further recruits, and there are few product sales to consumers. In order to recruit an effective sales force, Amway encourages its distributors to sponsor new distributors. This is not, however, a pyramid plan. In the Amway system, the incentive to recruit comes from the commission distributors receive on product sales by sponsored distributors in their organizations. But, by several rules, Amway requires that commissions are not paid unless the products are sold to consumers. Distributors must each sell to ten retail customers every month; the distributors must certify that 70% of the products purchased by them during the month have been resold; and inventory loading is further deterred by a rule requiring distributors

[6] To some extent the effect of these practices on consumers has been mitigated by the growing concentration and power of food chains and their tendency of using soap and detergents as loss leaders. (Diassi, Tr. 5534; Finding 176)

[7] In typical oligopolistic conduct, the major soap companies were slow to react to public demand for non-phosphate detergents in the early 1970's, allowing successful entry by at least one manufacturer selling through food stores. (Finding 178)

[8] Amway's turnover rate among distributors is better than most direct selling companies. (Findings 148, 162–163)

to buy back the inventory of any of their sponsored distributors leaving the business.

Amway has successfully entered the soap and detergents market because its distributors sell directly to consumers in their homes or businesses, rather than through retail grocery stores. Amway has achieved this method of distribution through several restraints on its distributors, including the retail store rule, the cross-group selling rule, and regulation of its distributors' advertising. These are reasonable vertical restraints. However, respondents went too far in controlling intrabrand competition while promoting interbrand competition. In addition to the beneficial restraints, respondents also stopped Amway distributors from competing among themselves for customers and fixed the prices at which Amway products are sold among distributors and to consumers. [76]

Distributor Restraints Are Vertically Imposed

The theory of the complaint anchors on the alleged horizontal nature of restrictions imposed on Amway distributors. Complaint counsel argue that the Amway Distributors Association is:

> [R]un by a clique of the most successful Amway Distributors. It exists for the sole purpose of protecting the interests of the successful from the hoards of competitors and newcomers who enter the distribution stream daily. Its mission is protection and its clout is termination. The Association is the root cause of all of the Section 5 violations, including the very existence of the Amway Sales and Marketing Plan. (CB, p. 3)

Complaint counsel state that about 35 Nutrilite distributors, including Mr. Van Andel and Mr. DeVos, decided collectively (1) that they needed a product, found one called "Frisk," and (2) that the "Marketing Plan" with its restrictions should be imposed on distributors. The uncontradicted testimony of Mr. Van Andel tells a different story. He testified that the Nutrilite distributors started having problems with their suppliers in 1959. (Van Andel, Tr. 1673–76):

> At that time, in order to attempt to bring this intramural fight to a conclusion and arbitrated, if you wish, a small group of distributors were appointed, of which I became the chairman, to try to work with both companies and try to work out an arrangement that would bring peace and tranquility back. [77]
>
> The arrangement to do this was not entirely successful. I met many times with the principals of both companies and this arrangement culminated in an offer by one of the companies to me to become president of their company. Mr. DeVos and I discussed this in some detail and we realized that the inherent problems were not being solved because it appeared to us the inherent problems were with the people who owned

those companies and that those problems would continue regardless of who managed them.

It appeared to us therefore the Nutra-Lite [sic] structure, the companies behind the Nutra-Lite distributing organization were in great danger of collapsing, that the time and effort they were putting into fighting amongst themselves instead of competing in marketplace would eventually destroy the company. Therefore it appeared to us if we were going to survive in business, if we were going to be able to continue and have some return on our 10 years of effort, it would be best if we would go into business ourselves, producing our own products and selling them through our own sales organization and controlling the entire distribution and manufacturing operation.

This then necessitated a very careful change in the distributor organization that we had built, which had been very strongly built with an allegience to Nutra-Lite food supplement as a product to sell. The Nutra-Lite organization as well as the Amway organization is built entirely of volunteers, people who voluntarily are distributors and it is very important if you are going to go into a different direction that the volunteers follow. They don't have to. They could all quit. [78]

So it was very necessary for us, we felt, to get their concurrence that our plans were good ones and that they would continue with us.

In order to do this, we felt we had to communicate with them very closely, and that at that time we put together a structure which I think you are familiar with, called Amway Distributor Association.

That association at that time was called the American Way Association; its name was changed later.

Its primary purpose was to attempt to communicate and hold together what business we had until we could shift gears and develop our own manufacturing operation, develop our own products and continue on.

This was basically the genesis of the Amway Corporation and we began with one or two products and continued on until where we are today.

Q. Did the American Way Association, when it was formed, have any particular products to distribute through the organizations of its members?

A. The American Way Association was never developed to be a product distributing structure. Rather it was in the nature of an association of independent contract or [sic] business people whereby they would have a means of formalized communication with Mr. DeVos and myself who proposed to set up the product distribution and manufacturing operation.

We developed a system whereby a board of directors of the association could be elected, a system whereby we could meet with them from time to time and discuss our plans and communicate with them and hopefully get them to agree to continue with us. [79]

Q. Did the association or did the association members determine a particular product that would be distributed through its organizations?