

SELLING THE RIGHT TO SELL THE SAME RIGHT TO SELL: APPLYING THE CONSUMER FRAUD ACT, THE UNIFORM SECURITIES LAW AND THE CRIMINAL CODE TO PYRAMID SCHEMES

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INTRODUCTION

Who would not like to make a 700% return on an investment in a relatively short period of time? Although this offer is obviously too good to be true, over the last sixty years countless people have fallen victim to this allure. In fact, fraudulent pyramid investment schemes recur regularly.¹ To address this problem, New Jersey's Legislature considered a bill which would have prohibited pyramid scams,² but ultimately declined to enact any new legislation. Although the state may bring civil actions against a promoter under the Consumer Fraud Act³ and the Uniform Securities Law⁴ and criminally prosecute under the theft statute⁵ and the Uniform Securities Law, case law, including the appellate division decision *State of New Jersey v. Frederica Bey*⁶ and the New Jersey Supreme Court decision *State v. DeLuzio*,⁷ raises the question of whether New Jersey, like Delaware and Michigan,⁸ should adopt legislation prohibiting pyramid promotion scams.

The defendant, in *Bey*, was acquitted of theft by deception. On appeal, the New Jersey Superior Court, Appellate Division, overturned the defendant's conviction for promoting an illegal lottery after concluding that pyramid schemes do not fall within the statute which prohibits illegal lotteries.⁹ This decision, however, is more significant for the fact that it reveals a conflict in two lines of

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¹ See Heine, *Point of No Return*, ASBURY PARK PRESS, April 2, 1993, at 1.

² See Appendix A (An Act prohibiting pyramid promotional schemes and supplementing Chapter 20 of Title 2C of the New Jersey Statutes S. 166, 1994 Sess. (1994)).

³ N.J. STAT. ANN. §§ 56:8-1 to -80 (West 1995).

⁴ N.J. STAT. ANN. §§ 49:3-47 to -76.

⁵ N.J. STAT. ANN. §§ 2C:20-1 to -37.

⁶ 261 N.J. Super. 182, 618 A.2d 373 (App. Div. 1992).

⁷ 136 N.J. 363, 618 A.2d 373 (1994).

⁸ See 6 DEL. LAWS § 2561(1) (1995); MICH. COMP. LAWS § 445.1528 (West 1989).

⁹ See N.J. STAT. ANN. § 2C:37-1(h).

cases: one construing pyramid investments as merchandise under the Consumer Fraud Act and the other holding pyramid investments as securities under the Uniform Securities Law. This article analyzes the potential adverse ramifications arising from this conflict.

WHAT IS A PYRAMID?

What is a pyramid scheme? Is it unlawful? If it is, what law applies and what are the consequences? Unfortunately, neither civil nor criminal law provides easy answers to these questions.

A pyramid scheme is similar to a chain letter. It is "inherently deceptive for the seemingly endless chain must come to a halt inasmuch as growth cannot be perpetual and the market becomes saturated by the number of participants. . . . [M]any participants are mathematically barred from ever recouping their original investments, let alone making profits."¹⁰ The traditional pyramid scheme, now known as "the Network," among other names, has predictably reemerged. The Network consists of a basic four-level pyramid.¹¹ One person occupies the top position of the pyramid, often referred to as the Chairman, and two people occupy the second level of the pyramid and are referred to as Presidents. Four people occupy the third level of the pyramid and are referred to as Executive Vice-Presidents, and eight people occupy the bottom level of the pyramid and are referred to as Vice-Presidents. For an initial payment of \$1,500, one buys into the bottom level of the pyramid. When all eight of the bottom level positions are filled, \$12,000.00 has been acquired by the pyramid. This \$12,000 is obtained by the Chairman, who theoretically leaves the pyramid. The pyramid now splits in two with each of the participants moving up one level. Thus, the two Presidents now become a Chairman in separate pyramids; the Executive Vice-Presidents now become Presidents, and the Vice-Presidents become Executive Vice-Presidents. It is also the obligation of the initial investors to refill the lowest level of the pyramid by bringing in eight new investors per pyramid, each supplying an additional \$1,500 investment.

Calculations prepared by the New Jersey Bureau of Securities reveal that for a person to advance from the bottom level to the Chairman position, 127 people must participate in this scheme.¹²

¹⁰ *Kugler v. Koscot Interplanetary, Inc.*, 120 N.J. Super. 216, 232, 293 A.2d 682, 691 (Ch. Div. 1972).

¹¹ See Appendix B.

¹² See Appendix C.

At about the twenty-first level of the pyramid, an entering participant would cash out at the twenty-fifth level, requiring participation of over 268,000,000 people. This is more than the population of the United States.

In a typical pyramid scheme the organizers or promoters usually advise potential investors that the pyramid is legal. Moreover, they often disavow the label "pyramid" and claim that they are marketing an investment network. Participants are required to invest in cash only and use nicknames or pseudonyms concealing their identity. Promoters often use group motivation as an incentive to invest, fostering an atmosphere similar to revival meetings. They also publish pamphlets encouraging investors by outlining the great returns and low risk.

The Bureau of Securities' calculations reveal, however, that pyramid schemes result in the loss of investment for most participants, although early investors may make the promised \$12,000 payoff at the Chairman level. This early payout provides an opportunity for the organizers themselves to reinvest profits initially made, thereby reaping multiple payouts in the scheme. Indeed, that pseudonyms or nicknames are often used makes it easier for the organizer to conceal his identity, occupy all of the upper levels of the pyramid, and be the sole recipient of all money invested.

The scheme will ultimately fail given the large number of participants needed to keep the pyramid going. Even the investor entering at level one must rely on 126 other individuals to invest. Most investors, however, fail to realize the need for such a great number of participants. The scheme also has other inherent pitfalls. Participants tend to recruit people they know and therefore cause an undue concentration of recruiters trying to attract others in the immediate vicinity. Thus, the pool of potential investors is often much smaller than participants initially realize. Moreover, participants are never told on which level they are entering the pyramid and are therefore unaware of how many participants have already invested before them and that the scheme is on the verge of collapse. Thus, the organizers prevent potential investors from acquiring information, namely the size of the participant pool, which would affect their judgment. This is the core deception of the scheme. Pyramid sales are also sometimes used to promote a particular product. These pyramid sales, however, are often just as fraudulent as the traditional pyramid investment scam.

Although pyramid scams may be prosecuted under state civil

and criminal statutes, case law reveals a conflict in how they are defined and, therefore, which law applies.

THE CONSUMER FRAUD ACT

The New Jersey Consumer Fraud Act prohibits fraud in the sale or advertisement of merchandise. Merchandise is defined by the statute as "any objects, wares, goods, commodities, services or anything offered, directly or indirectly to the public for sale."¹³ The question becomes whether a pyramid investment is a sale of merchandise.

When the Consumer Fraud Act was first adopted in 1960, the term merchandise was defined as "any objects, wares, goods, commodities, or services."¹⁴ In 1967, a bill was introduced amending the definition to include "real estate, securities, services or anything offered directly or indirectly to the public."¹⁵ Prior to passage of the bill, however, the words "real estate" and "securities" were deleted.¹⁶ The appellate division has held that the Legislature intentionally deleted those words to eliminate these two areas of commercial activity from the purview of the statute.¹⁷ Thus, if pyramid sales are securities, then they are not merchandise and the Consumer Fraud Act is inapplicable. In this regard, the New Jersey Supreme Court has reasoned that separate state agencies should not have the right to exercise concurrent jurisdiction and control over an area because of the real possibility of conflicting determinations, rulings, and regulations affecting the identical subject matter.¹⁸

In *Kugler v. Koscot Interplanetary, Inc.*,¹⁹ the Attorney General of New Jersey brought suit under the Consumer Fraud Act against a cosmetics company which organized its sales under a pyramid concept. For a \$5,000 investment, an investor would become a distributor of Koscot's cosmetics. This entitled the distributor to a 65% discount on all future purchases of Koscot's cosmetics. For a

¹³ N.J. STAT. ANN. § 56:8-1(c).

¹⁴ See *Neveroski v. Blair*, 141 N.J. Super. 365, 377, 358 A.2d 473, 479 (App. Div. 1976).

¹⁵ See *id.*

¹⁶ *Id.* Real estate, however, was added to N.J. STAT. ANN. § 56:8-2 in 1976. See *id.* Thus, the law now covers fraud in connection with the sale or advertisement of any merchandise or real estate.

¹⁷ *Neveroski*, 141 N.J. Super. at 378, 358 A.2d at 480.

¹⁸ *Daaleman v. Elizabethtown Gas Co.*, 77 N.J. 267, 272, 390 A.2d 566, 569 (1978).

¹⁹ 120 N.J. Super. 216, 293 A.2d 682 (Ch. Div. 1972). See also Note, *Consumer Fraud - New Jersey Consumer Fraud Act Bars Pyramid Sales Schemes*, 27 RUTGERS L. REV. 220 (1973) (providing a different analysis of *Kugler v. Koscot*).

\$2,000 investment, an investor would be designated a supervisor and would be entitled to a 55% discount on all future purchases of Koscot cosmetics. Distributors and supervisors could enlist beauty advisors who would sell Koscot cosmetics at a 40% discount. Additionally, incentives were given to distributors to recruit supervisors, as well as to supervisors to buy into the distributor slot and recruit supervisors to replace their positions. The chancery division in *Koscot* noted that:

Koscot's distribution program is predicated upon a referral sales and a pyramiding concept, a practice which is known as referral or pyramid sales. It is an arrangement whereby one is induced to buy upon representation that he cannot only regain his purchase price but also earn profits by selling the same program to the public. It thus involves the purchase of the right to sell the same right to sell.²⁰

Apparently unconcerned with the fact that cosmetics were actually sold along with distributorships, that court emphasized that a major portion of Koscot's revenues was derived from the sale of distributorships rather than from the sale of cosmetics. Moreover, the court found that Koscot misrepresented the potential return on an investment, among other things, in its literature and at its emotionally charged "Golden Opportunity" meetings. Consequently, the court held that the New Jersey Consumer Fraud Act prohibited Koscot's sales practice. The chancery division, however, never made a finding that pyramid sales are "merchandise."²¹ Despite the failure to specifically address the issue of whether a pyramid is "merchandise," the New Jersey Superior Court, Appellate Division, has cited *Kugler* with approval.

The defendant in *State of New Jersey v. Frederica Bey* argued for reversal of her criminal conviction for promoting gambling by contending that the pyramid scheme she promoted was legal and the participants understood the plan as legal. The court rejected her argument as clearly incorrect, citing *Kugler* and noting that "pyramid sales schemes are prohibited by the Consumer Fraud Act."²² Moreover, the scheme employed in *Bey* was a pure pyramid and did not involve the sale of any product. Neither court, however, made any finding that pyramid investments are merchandise as defined in the Consumer Fraud Act.

²⁰ *Kugler*, 120 N.J. Super. at 232, 293 A.2d at 691.

²¹ *Id.* at 233, 293 A.2d at 691.

²² *Bey*, 261 N.J. Super. at 184, 618 A.2d at 374 (citing *Kugler*, 120 N.J. Super. at 233-35, 293 A.2d at 691-92).

Moreover, other courts have relied on *Kugler*. The law division, in *Morgan v. Airbrook Limousine Inc.*,²³ held that the sale of a franchise is "merchandise" within the meaning of the Consumer Fraud Act, rejecting the plaintiff's claim that the Franchise Practices Act²⁴ would therefore subject franchise orders to two distinct or conflicting regulatory schemes.²⁵ Rather, the *Morgan* court, relying on *Kugler*, concluded that a franchise is subsumed within the terms "commodities, services or anything offered directly or indirectly to the public for sale."²⁶ *Morgan* also relied on an Illinois case, *People ex rel Scott v. Cardet Int'l, Inc.*,²⁷ which held that distributorships were services and intangibles within the statutory definition of merchandise under the Illinois Consumer Fraud Act. Thus, the Illinois court concluded that the term "services" within section 1(c) of the Consumer Fraud Act includes the type of operational, supervisory, and marketing assistance provided by a franchiser.

Morgan, however, also revealed the complexity of this issue by recognizing that several other courts have held that sales of franchises fall within the ambit of federal and state securities laws. In fact, those securities law cases reveal the more well-reasoned approach to addressing the pyramid scheme.

THE UNIFORM SECURITIES LAW

New Jersey's Bureau of Securities considers pyramid scams a violation of the Uniform Securities Law and may administratively enjoin operators with a cease and desist order.²⁸ In so doing, the Chief of the State Bureau of Securities makes findings: (1) that the pyramid scheme is an investment contract and security as defined in section 2(m) of the act;²⁹ (2) that participations in the scheme are offered or sold while they are not registered or exempt, pursuant to section 13 of the act;³⁰ and (3) that such a sale is unlawful, in

²³ 211 N.J. Super. 84, 510 A.2d 1197 (Law Div. 1986).

²⁴ N.J. STAT. ANN. § 56:10-1.

²⁵ The court came to this conclusion because the New Jersey Franchise Practices Act, N.J. STAT. ANN. §§ 56:10-1 to -29, does not provide for a comprehensive regulatory scheme. The Franchise Practices Act, however, does provide for rules and regulations on motor vehicle franchises. N.J. STAT. ANN. § 56:10-25.

²⁶ *Morgan*, 211 N.J. Super. at 98, 510 A.2d at 1204.

²⁷ 321 N.E.2d 386, 390 (Ill. App. Ct. 1974).

²⁸ See N.J. STAT. ANN. § 49:3-67 which empowers the bureau chief to promulgate orders which are reasonably necessary to carry out the law.

²⁹ N.J. STAT. ANN. § 49:3-49(m) (defining security).

³⁰ N.J. STAT. ANN. § 49:3-60 (proscribing sales of an unregistered security).

violation of section 5 of the act³¹ because of the material misleading statements made by the offerors.³²

Section 2(m) of the Uniform Securities Law defines security as "any note; stock, treasury stock; bond; debenture; evidence of indebtedness; . . . [or any] *investment contract*."³³ Section 1 of the act provides that this statute shall be "construed as to effectuate its general purpose to make uniform the laws of those states which enact similar laws and to coordinate the interpretation and administration of this law with related federal regulations."³⁴ As such, the New Jersey judiciary often looks to federal decisions under the Securities Act of 1933³⁵ for guidance in interpreting cases under New Jersey's Uniform Securities Law.³⁶

In *Securities and Exchange Commission v. Howey*,³⁷ the United States Supreme Court held that an "investment contract" for purposes of the Securities Act means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."³⁸ In support of its interpretation of the term investment contract, the Court, in footnote 4, cites *Stevens v. Liberty Packing Corp.*³⁹ to show the broad definition of the term found in state decisions.

In that case, Liberty offered an absentee ownership agreement, called a lease, whereby an investor could purchase four female rabbits. The does were leased back to Liberty for breeding. Liberty would thereafter divide the offspring between it and the investor. The investor also had the promise that Liberty would buy each of the offspring for one dollar a piece. The second part of the scheme entails a buy-back contract where Liberty would sell four does and a buck and the investor would raise them in his back yard. Liberty agreed, however, to buy the offspring at one dollar a piece.

Liberty published pamphlets assuring the investor that he was

³¹ N.J. STAT. ANN. § 49:3-52(b) (proscribing fraud in connection with the sale of a security).

³² See e.g. In the Matter of Vernon Camhi and Morris Padulo, Jr. and In the Matter of Salvatore A. Graci and Stephen J. Delpome.

³³ N.J. STAT. ANN. § 49:3-49(m) (emphasis added).

³⁴ N.J. STAT. ANN. § 49:3-48.

³⁵ 15 U.S.C. § 77b.

³⁶ See *AMR Realty Co. v. State*, 149 N.J. Super. 329, 373 A.2d 1002 (App. Div. 1977).

³⁷ 328 U.S. 293 (1946).

³⁸ *Id.* at 298-99.

³⁹ 111 N.J. Eq. 61, 161 A. 193 (1932).

guaranteed against loss, calculating the significant income which could be made from the investment. Liberty, however, reserved the right to arbitrarily condemn the herd of offspring and put an end to its obligation. The court concluded, in a description strikingly similar to the Network, that "the scheme is pure swindle, in which the money of new purchasers is used to placate earlier victims, only to collapse when there are no more to plunder."⁴⁰ The court found "[t]he home treatment lease and the 'buy-back' contract . . . securities within meeting of our securities act."⁴¹ Moreover, the court noted, as is common in pyramid schemes, that some of the investors refused to complain. In this regard, the court said:

[o]rdinarily, a fraud so gross as this one would be enjoined almost as a matter of routine, but, as unconvinced victims protest against our intention and, as we are informed, other unscrupulous operators promoting the same scheme are invading our state to trick the unwary, we feel it our duty to expose the cheat, to caution the unsuspecting and to warn the swindlers.⁴²

Additionally, the court stated:

The objects [of the Securities Act], then, are to prevent fraud and unfair dealing in securities, as well as to prevent honest people, free from sinister influences, from investing in uncertain, ephemeral, "get rich quick" stocks and securities. In other words, it is a statute designed, in part, to protect credulous persons against their own inherent weakness—a weakness akin to the gamblers hope of winning a prize. We think it is well settled that both of these objects, within constitutional bounds, properly come within regulations prescribed by the police powers of the State.⁴³

In *Securities and Exchange Commission v. Glenn Turner, Inc.*,⁴⁴ the Ninth Circuit interpreted the phrase "with profits to come solely from the efforts of others," enunciated in *Howey*, to mean "whether the efforts made by those other than an investor are the undeniably significant ones, the essential managerial efforts which affect the failure or success of the enterprise."⁴⁵ In so doing, the United States Court of Appeals for the Ninth Circuit relied on language in *Howey* that explained that the definition of a security embodies a "flexible rather than a static principal, one that is capable of adap-

⁴⁰ *Id.* at 65, 161 A. at 195.

⁴¹ *Id.*

⁴² *Id.* at 62-65, 161 A. at 193-95.

⁴³ *Id.* at 66, 161 A. at 195.

⁴⁴ 474 F.2d 476 (9th Cir. 1973).

⁴⁵ *Id.* at 482.

tation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."⁴⁶

The United States Court of Appeals for the Fifth Circuit in *Securities Exchange Commission v. Koscot Interplanetary Inc.*⁴⁷ adopted the test from *Turner*. This federal case, brought by the Securities and Exchange Commission against Koscot, was premised upon the same cosmetics distribution scheme as outlined in the New Jersey chancery division opinion in *Kugler*. In the federal case, however, the Securities and Exchange Commission alleged that Koscot had committed fraud in connection with the sale of a security.

In reversing the district court's dismissal of the government's case, the Fifth Circuit held that Koscot's scheme satisfied all three elements of the *Howey* test. In rendering its decision, the Court of Appeals noted that the United States Supreme Court, in *Howey*, relied on *Stevens* to illustrate the broad reach of the Uniform Securities Law. The same conclusion was reached by the Michigan Court of Appeals in *People v. Cooper*⁴⁸ upholding the defendant's criminal conviction under the Uniform Securities Law.⁴⁹

THE CONFLICT

In *Stella v. Dean Witter Reynolds Inc.*,⁵⁰ the New Jersey appellate division held that fraud in the sale of shares of stock or other securities is not within the scope of the New Jersey Consumer Fraud Act. That case involved fraud by a broker at Dean Witter who was ultimately sued by a defrauded investor. On appeal, the court considered, among other things, whether the investor was entitled to treble damages under the Consumer Fraud Act. The court resolved that issue in the negative, thereby undermining the most punitive remedy available in a civil case. Thus, there is a conflict in how these schemes may be redressed. If the Michigan Court of Appeals and New Jersey Bureau of Securities are correct, and pyramid sales are securities under *Howey*, then the New Jersey Appellate Division ruling in *Stella*—that the Consumer Fraud Act may not be

⁴⁶ *Id.* at 481 (citing *Howey*, 328 U.S. at 299).

⁴⁷ 497 F.2d 473 (5th Cir. 1974).

⁴⁸ 421 N.W.2d 177 (1987).

⁴⁹ Indeed, contrary to the decision reached by the Michigan Court of Appeals, decisions in other jurisdictions have reached other conclusions. *See, e.g.*, *State v. Hawaii Mkt. Ctr.*, 485 P.2d 105 (1971). The Hawaii decision has been criticized by the Ninth Circuit as a strict interpretation rather than the flexible one suggested by the United States Supreme Court. *Turner*, 474 F.2d at 482.

⁵⁰ 241 N.J. Super. 55, 574 A.2d 468 (App. Div. 1990).

used to redress securities violations—makes erroneous the *Kugler* holding that the Consumer Fraud Act outlaws pyramids. Indeed, that the appellate division decision in *Bey* cited *Kugler* with approval makes the conflict more acute. This issue is therefore ripe for judicial or legislative resolution.

The principal weakness in relying on the court's conclusion in *Bey*—that pyramid sales schemes are prohibited by the Consumer Fraud Act—is that its finding is merely dicta. The appellate division was construing the criminal code in *Bey*, not the Consumer Fraud Act. Additionally, the defendant in *Bey* offered nothing to her investors in the way of "objects, wares, goods, commodities or services." Moreover, although *Kugler* could have explicitly held that the sale of cosmetics by Koscot was a sale of merchandise giving the Attorney General jurisdiction under the Consumer Fraud Act, it did not. The chancery division appeared to focus solely on the sale of Koscot "distributorships."

Indeed, it does appear that the investor in a fraudulent pyramid scheme must rely on the efforts of his successors to solicit new investors to keep the cycle going. The chairperson, who receives the investment, leaves the group. Therefore, the securities law analysis focusing on the three-prong *Howey* test of investment of money, in a common enterprise, with profits to come solely from significant essentially managerial efforts made by those other than an investor, appears to more accurately describe a pyramid investment. The investor must rely on those coming after him to recruit additional investors; he is not relying on the "services" of the chairperson.

Civil prosecution under either theory, however, may be made in the alternative. For example, if the Attorney General moves under the Consumer Fraud Act and the defendant interposes a defense that the pyramid sale is a security rather than merchandise, the Attorney General may amend his civil complaint to now allege a violation of the securities law. This strategy, however, is unavailable in a criminal prosecution because there is no criminal violation of the Consumer Fraud Act.

CRIMINAL PROSECUTION

In *State v. Deluzio*, the New Jersey Supreme Court confirmed the appellate division's opinion in *Bey* that pyramid organizers are potentially subject to the criminal theft by deception penalties. A prosecution under theft by deception, however, often causes proof problems. The defendant invariably will argue, as did the defend-

ant in *Bey*, that the investment was legal and that all the participants understood the plan, implying that the participants understood the risks attendant to investing in this scheme. *Bey* definitively rejected the first argument, but in so doing relied on *Kugler*.

The second argument, however, is more compelling; an investor may understand the risks associated with buying into a pyramid. Indeed, one could make the mathematical calculations to determine how many people are required to work through the completion of the pyramid. Thus, a jury may conclude that no deception has occurred despite the organizer's failure to reveal all information which affects an investor's judgment. The jury's verdict, in favoring of *Bey* on the theft by deception charge suggests that is precisely what the jury concluded in that case.

Moreover, *DeLuzio* confirmed the *Bey* holding that a pyramid scheme was not an illegal lottery or policy or numbers game under the gambling statute⁵¹ reasoning that

when the indictment here is read against the statutory definition of a lottery and the proofs in this case, it appears that the defendant was not engaged in gambling by means of a lottery (or a policy or numbers game). Because the facts proven at trial could not satisfy the statutory definition of a lottery, defendant's conviction for materially aiding such "lottery" cannot stand.⁵²

This holding, along with *Kugler* and *Stella*, reveal the inadequacy of current law to deal with this type of swindle.

Although it appears from the case law in other jurisdictions that pyramid sales are securities, that question is unresolved under the New Jersey decisions in *Kugler*, *Stella* and *Bey*. This unresolved question of whether pyramid sales are merchandise or securities casts a cloud over criminal prosecution under New Jersey's Uniform Securities Law. Section 23(a)⁵³ provides that any person who willfully violates any provision of the Uniform Securities Law is guilty of a crime of the third degree. Based on the findings of the Chief of the Bureau of Securities and under *Howey* and its progeny, pyramid sales are securities and investment contracts; promoters of these scams would, therefore, be subject to criminal prosecution

⁵¹ N.J. STAT. ANN. § 2C:37-1(h).

⁵² *Bey*, 261 N.J. Super at 189, 618 A.2d at 377, approved in *State v. DiLuzio*, 136 N.J. 363 (1994).

⁵³ N.J. STAT. ANN. § 49:3-70(a).

under the act. Thus, a willful violation of section 5(a),⁵⁴ proscribing material misleading statements in connection with the sale of securities, is a third degree crime. Indeed, the application of this law addresses the concern raised in *Liberty* by protecting people against their own weaknesses.

Koscot and *Bey*, however, may provide a plausible, although weak, defense: pyramid sales are not securities, but rather merchandise under the Consumer Fraud Act. Until a court resolves this issue, criminal prosecution under the Uniform Securities Law is dubious. Moreover, unlike civil remedies, there is no alternative for criminal prosecution under the Consumer Fraud Act.

In 1993, a New Jersey county grand jury indicted four individuals in *State of New Jersey v. Nickel*⁵⁵ for, among other things, fraud in connection with the sale of a security and sale of an unregistered security. This indictment is predicated on the pyramid investment scam known as the Network. Although that case provides the ideal vehicle to test whether pyramid investments are merchandise or securities, this issue has not been addressed by an appellate court.

In the absence of judicial resolution of this case of first impression, the Legislature's consideration of Senate Bill No. 166, "An act prohibiting promotional schemes and supplementing Chapter 20 of Title 2C of the New Jersey Statutes,"⁵⁶ appeared to be a partial resolution to the apparent gap in prosecuting pyramid schemes. That bill, if enacted into law, would have criminalized operating or promoting a pyramid promotional scheme. The bill defined a pyramid promotional scheme as:

any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from any person's introduction of other persons into participation in the plan or operation rather than from the sale of goods services or intangible property.⁵⁷

Although the bill would have prohibited the promotion of a scheme that "involves the purchase of the right to sell the same right to sell,"⁵⁸ enacting this proposed legislation would leave unresolved the apparent conflict in the civil remedies until judicial resolution of the merchandise verses securities question.

⁵⁴ N.J. STAT. ANN. § 49:3-52(b).

⁵⁵ Indictment No. 93-5-789.

⁵⁶ See Appendix A.

⁵⁷ See Appendix A.

⁵⁸ *Koscot*, 120 N.J. Super. at 232, 293 A.2d at 691.

CONCLUSION

Since 1932 and the decision in *Liberty*, people have been willing to invest money in scams mathematically certain to collapse. Since that time, the United States Supreme Court, the New Jersey Supreme Court, and courts in other jurisdictions have, in the words of *Liberty*, made decisions affecting the state's attempt to protect credulous people from their own weakness, something akin to a gambler's hope. Ironically, however, the New Jersey Supreme Court has held that this scam does not fall within New Jersey's gambling statute and the application of other laws is uncertain not because, as the New Jersey Supreme Court feared, separate state agencies have issued conflicting rulings, but because the judiciary has rendered conflicting opinions. Two opportunities to drain this quagmire have now presented themselves, but the question remains whether promoters will successfully continue to sell the same right to sell.

APPENDIX A
SENATE, No. 166
STATE OF NEW JERSEY

Introduced Pending Technical Review by Legislative Counsel
PRE-FILED FOR INTRODUCTION IN THE 1994 SESSION

By Senator PALAIA

1 AN ACT prohibiting pyramid promotional schemes and
2 supplementing Chapter 20 of Title 2C of the New Jersey
3 Statutes.

4
5 BE IT ENACTED by the Senate and General Assembly of the
6 State of New Jersey:

7 1. a. As used in this section:

8 (1) "Participant" means a person who contributes money into a
9 pyramid promotional scheme but does not promote, organize or
10 operate the scheme;

11 (2) "Promoting a pyramid promotional scheme" means inducing
12 or attempting to induce one or more other persons to become
13 participants, or assisting another person in promoting a pyramid
14 promotional scheme by any means including the provision of
15 references.

16 (3) "Pyramid promotional scheme" means any plan or
17 operation by which a participant gives consideration for the
18 opportunity to receive compensation which is derived primarily
19 from any person's introduction of other persons into participation
20 in the plan or operation rather than from the sale of goods,
21 services or intangible property by the participants or other
22 persons introduced into the plan or operation.

23 (4) "Compensation" means payment of any money, thing of
24 value, or financial benefit. Compensation does not include
25 payment based on sales of products by the person or by other
26 participants in the plan to anyone, including a participant in the
27 plan, who is purchasing the products for actual use or
28 consumption.

29 (5) "Consideration" means the payment of cash or the purchase
30 of products but does not include the purchase of products
31 furnished at cost to be used in making sales and not for resale,
32 the purchase of products where the seller offers to repurchase
33 the products acquired by the participant from the seller at
34 reasonable commercial terms nor does it include time and effort
35 spent in pursuit of sales or recruiting activities.

36 (6) "Products" means goods, services, or intangible property of
37 any kind.

38 (7) "Reasonable commercial terms" includes repurchase of all
39 unencumbered products which are in an unused, commercially
40 resalable condition within one year from the participant's date of
41 purchase; such repurchase shall be at a price not less than 90
42 percent of the original net cost to the participant of the products
43 being returned. For purposes of this paragraph, "original net
44 cost" means the amount actually paid by the participant for the
45 products, less any consideration received by the participant for

1 purchase of the products being returned. Products which are no
2 longer marketed by a program shall be deemed "resalable" if the
3 products are otherwise in an unused, commercially resalable
4 condition and are returned to the seller within one year from the
5 participant's date of purchase; provided, however, that products
6 which are no longer marketed by a program shall not be deemed
7 "resalable" if the products are sold to participants as
8 nonreturnable discontinued, seasonal, or special promotion items
9 and the nonreturnable nature of the products was clearly
10 disclosed to the participant prior to purchase.

11 b. A person commits a crime if he contrives, prepares,
12 establishes, operates, advertises, sells, promotes or participates
13 in a pyramid promotional scheme.

14 c. (1) Any person who violates subsection b. of this section by
15 contriving, preparing, establishing, operating, advertising or
16 promoting a pyramid promotional scheme is guilty of a crime of
17 the third degree.

18 (2) Any person who violates subsection b. of this section by
19 participating in a pyramid promotional scheme is guilty of a
20 crime of the fourth degree except that if the amount of
21 consideration which the person contributed to a pyramid
22 promotional scheme was \$100.00 or less, the person is guilty of a
23 disorderly persons offense.

24 d. (1) It shall be no defense to a prosecution for a crime under
25 this section that the scheme or plan involved both a franchise to
26 sell a particular product and the authority to sell additional
27 franchises if the emphasis of the scheme is on the sale of
28 additional franchises.

29 (2) It shall be no defense to a prosecution for a crime under
30 paragraph (2) of subsection b. of this section that the person,
31 after signing an agreement to participate, later withdraws from
32 the pyramid promotional scheme.

33 2. This act shall take effect immediately.
34
35

36 STATEMENT 37

38 This bill would provide criminal penalties for operating and
39 participating in pyramid promotional schemes. This bill defines
40 "pyramid promotional scheme" to mean any plan or operation by
41 which a participant gives consideration for the opportunity to
42 receive compensation which is derived primarily from the
43 introduction of other persons into the plan or operation which
44 than from the sale of goods, services or intangible property by
45 the participants.

46 With regard to penalties, the bill provides that a person who
47 establishes, operates or promotes a pyramid promotional scheme
48 would be guilty of crime of the third degree. A person who
49 participates in a pyramid promotional scheme would be guilty of
50 a crime of the fourth degree, except that if the amount that the
51 person contributed to the scheme was \$100.00 or less, the person
52 is guilty of a disorderly persons offense.

SENATE JUDICIARY COMMITTEE
STATEMENT TO
SENATE, No. 166
STATE OF NEW JERSEY

Dated May 5, 1994

The Senate Judiciary Committee reports favorably Senate Bill No. 166

This bill would provide criminal penalties for operating and participating in pyramid promotional schemes. The bill defines "pyramid promotional scheme" to mean any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from the introduction of other persons into the plan or operation rather than from the sale of goods, services or intangible property by the participants.

With regard to penalties, the bill provides that a person who establishes, operates or promotes a pyramid promotional scheme would be guilty of a crime of the third degree. A person who participates in a pyramid promotional scheme would be guilty of a crime of the fourth degree, except that if the amount that the person contributed to the scheme was \$100.00 or less, the person is guilty of a disorderly persons offense.

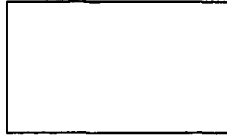
This bill was prefiled for introduction in the 1994 session pending technical review. As reported, the bill includes the changes required by technical review which has been performed.

1
2
3
4

Establishes criminal penalties for operation or participating in pyramid promotional schemes.

APPENDIX B
THE NETWORK

CHAIRPERSON



PRESIDENT



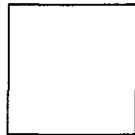
PRESIDENT



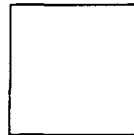
EXEC. VICE PRES.



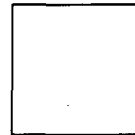
EXEC. VICE PRES.



EXEC. VICE PRES.



EXEC. VICE PRES.



VICE PRES.



VICE PRES.



VICE PRES.



VICE PRES.



VICE PRES.



VICE PRES.



VICE PRES.



VICE PRES.



- YOU MUST PAY TO PLAY
- YOU MUST BRING AT LEAST ONE PERSON INTO THE NETWORK
- YOU MUST ATTEND THE MEETINGS OR BE REPRESENTED.
- ABSOLUTELY NO PIGGY-BACKING

APPENDIX C

Entry Level	Number of Charts	Additional Persons Needed For All Participants to Advance to Next Level	Total Participants to Date	Return of Profit If Entered at Level
1	1	8	15	
2	2	16	31	
3	4	32	63	
4	8	64	127	1
5	16	128	255	2
6	32	256	511	3
7	64	512	1023	4
8	128	1024	2047	5
9	246	2048	4095	6
10	512	4096	8191	7
11	1024	8192	16383	8
12	2048	16384	32767	9
13	4096	32768	65535	10
14	8192	65536	131071	11
15	16384	131072	262143	12
16	32768	262144	524287	13
17	65536	524288	1048575	14
18	131072	1048576	2097151	15
19	262144	2097152	4194303	16
20	524288	4194304	8388607	17
21	1048576	8388608	16777215	18
22	2097152	16777216	33554431	19
23	4194304	33554432	67108863	20
24	8388608	67108864	134217727	21
25	16777216	134217728	268435455	22
26	33554432	268435456	536870911	23

The above chart is based upon the most common type of pyramid, a four level pyramid.

