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Chief
Joseph
Thompson
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IN THE
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

U.S. Court of Appeals Docket Number: 94-16477
Lower Court Docket Number: CV-92-04133-SBA

SHAUN WEBSTER and ROBERT LIGON, on behalf of themselves and all others similarly situated,
Plaintiffs-Appellants,

v.

OMNITRITION INTERNATIONAL, INC., JIM FOBAIR, ROGER DALEY, CHARLES RAGUS and JERRY RUBIN
Defendants-Appellees.

BRIEF OF AMICUS CURIAE DIRECT SELLING ASSOCIATION IN SUPPORT OF PETITION FOR REHEARING AND SUGGESTION OF REHEARING EN BANC

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases **Page**

Statutes

Foreign Statutes

TABLE OF AUTHORITIES - Continued

Miscellaneous

TABLE OF AUTHORITIES - Continued

STATEMENT OF INTEREST OF AMICUS CURIAE

The Direct Selling Association (DSA) is a national trade association headquartered in Washington, D.C. It represents companies which distribute products to customers through independent salespersons who personally demonstrate and explain the products to the consumer, usually in the home or work place. Direct sellers are perhaps best known to the public as person-to-person, door-to-door, or home party plan sellers. Direct selling provides an alternative distribution methodology by which companies (often small or new) may offer quality products and services to consumers without having to overcome the substantial advertising expenditures and other barriers to entry through more traditional distribution systems. Direct selling enables direct selling companies to overcome these barriers through the efforts of direct salespersons who provide personal demonstration, home delivery and a variety of other services which are not available in most retail outlets today. In 1994, over 6.3 million individuals sold directly, generating over $16.55 billion in estimated retail sales value.[1] We estimate that DSA's membership of 146 companies accounts for more than 90% of the industry's annual sales volume. At least 10 members of DSA are publicly traded companies.

Over 70% of DSA members classify themselves as multilevel marketing companies.[2] Multilevel marketing is a way of organizing a direct selling business in which customers are offered the opportunity to share with others their enthusiasm for a product and to receive rewards from sales to those consumers and from sales of and to those who they may in turn introduce to the company. Most of our salespeople and distributors use

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[1] 1995 Direct Selling Industry-Wide Growth and Outlook Survey.

[2] Id.

direct selling as a second, third, even fourth source of income. 76.3% of direct salespeople are female, 12.5% are African Americans, 4.7% are Hispanic Americans, 1% are Asian Americans and .5% are Native Americans. 8% of direct salespeople have a physical disability and 4.5% are over 65 years of age.[3] There are fundamentally six types of salespeople in direct selling. Many people become involved in direct selling to buy products they like at wholesale or discount prices. These wholesale or discount buyers can make up a significant portion of a direct selling company's customer and distributor base. Others join our companies to fulfill personal short-term objectives (e.g., working in December to earn holiday gift money.) The ease of entry into and exit from our business facilitates this type of sales activity. Others use our industry as a year round supplemental income source, but only work a few hours per week. Their extra direct selling income improves the quality of their lives, often keeping them in the middle class. Some direct sellers pursue their businesses as careers, devoting 30 hours or more per week to the business. Yet other individuals start direct selling businesses to gain social contacts or recognition otherwise missing in their lives. Finally, many direct sellers so believe in their products that they are driven to share them with family, friends and neighbors. People can move in and out of these categories and can be in more than one category simultaneously.

DSA is vitally interested in the proceedings of this case and the decision of the Court in this matter. Over many years, DSA has worked toward the development of clear and reasonable standards which have been used by law enforcement officials, legislators, legitimate businesses, and the public, to distinguish pyramid schemes from bona fide direct

[3] Id.

selling companies.[4] DSA submits this brief as part of its ongoing effort to ensure that illegal pyramids are identified and prosecuted, and that the public continues to receive the benefits of the products and services of bona fide marketing companies.[5]

The Court asserts that the central issue "is whether Omnitrition's marketing program is a pyramid scheme." Webster v. Omnitrition, 96 Daily Journal D.A.R. 2427, at 2428. In resolving that issue as to Omnitrition, the Court uses broad statements concerning the types of rules (i.e., the company's inventory buyback obligation, the "ten-customer rule", and the "70% rule", discussed infra) relied upon by DSA members to clearly distinguish themselves from pyramid schemes.[6]

The Court's discussion of the efficacy of those rules and the legality of compensation paid on the basis of the purchases by recruits is troubling because it could inadvertently and inappropriately call into question aspects of many legitimate companies' marketing and compensation plans, as well as long-established consumer protection safeguards. DSA believes it is vital that the Court have a full and complete understanding of the current, accepted business practices of direct selling companies, as well as the pertinent safeguards which assist distributors and the public in their efforts to distinguish between pyramid frauds and legitimate opportunities. DSA is gravely concerned that, in

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[4] DSA has participated in earlier relevant litigation as an amicus. See, e.g., State ex rel. Miller v. American Professional Marketing, Inc., 382 N.W.2d 117 (Iowa, 1986); In re Ger-Ro-Mar, Inc., 84 F.T.C. 95 (1974) (amicus br. of DSA). Additionally, DSA has been a defendant in a law suit brought by an established pyramid scheme for not allowing that pyramid into DSA membership.

[5] DSA and its Foundation have co-authored many publications with the cooperation of law enforcement and other public and quasi-public agencies for purposes of educating the public on the differences between pyramid schemes and multilevel companies. See, e.g., "Pyramid Schemes: Not What They Seem" (1991) (published in cooperation with the Federal Trade Commission and the National District Attorneys Association). "Promises. Check 'em Out!: Business Opportunity Fraud" (1994) (published in cooperation with the National District Attorneys Association). See, also, Mario Brossi & Joseph N. Mariano, Multilevel Marketing - A Legal Primer (1991).

[6] For purposes of this brief, DSA adopts Omnitrition's statement of the case and facts.

determining that the summary judgment was premature and that the Omnitrition sales plan did not satisfy the standards set out in In re Amway, 93 F.T.C. 618 (1979), the Court may have inadvertently misapplied Amway and made statements which would cast doubt on the legality of some essential aspects of bona fide marketing plans. DSA takes no position, however, regarding the enforcement or effectiveness of similar rules adopted by Omnitrition or any other factual matters presented to the Court.

I. THE COURT ERRS IN SUGGESTING THAT, PRIMA FACIE, A MULTILEVEL MARKETING PLAN THAT CALCULATES COMPENSATION BASED ON PRODUCT ORDERS COULD BE A PYRAMID SCHEME WITHOUT REGARD TO THE EXISTENCE AND EFFECTIVENESS OF AN INVENTORY REPURCHASE POLICY AND OTHER DISTINGUISHING FEATURES.

In its initial analysis of the Omnitrition plan, the Court suggests that a multilevel marketing plan which offers compensation based on a participant's product orders could, on its face, be a pyramid scheme which rewards recruitment rather than retailing.[7] Whatever merit such a suggestion may (or may not) have regarding the Omnitrition plan, there is no judicial precedent and no basis in fact for such a broad pronouncement as to other plans which are not before the Court. The Court erred in suggesting that compensation based on product orders is necessarily unrelated to the sale of product to ultimate users and thus, prima facie, indicative of a pyramid scheme.[8] Bona fide marketing

[7] "...the [Omnitrition] supervisor receives the right to sell the products and earn compensation based on product orders made by the supervisor's recruits. This compensation is facially 'unrelated to the sale of product to ultimate users' because it is paid on the suggested retail price of the amount ordered from Omnitrition. rather than based on actual sales to ultimate consumers...Omnitrition's program appears to be a pyramid scheme...[t]he mere structure of the scheme suggests that Omnitrition's focus was in promoting the program rather than selling the product." Webster. 96 Daily Journal at 2429.

[8] We attempt to make no assessment of the evidence produced by the parties regarding whether. in fact. compensation was awarded by Omnitrition on the basis of mere recruitment or product sales to ultimate user.

plans almost invariably award compensation in a manner similar or identical to that described by the Court, thereby lawfully providing incentives for participants to recruit others to sell products to consumers. While these incentives are measured initially based upon the purchases made by recruits of the participant, they are made effectively contingent upon sales to ultimate consumers taking place by adoption and enforcement of rules which, together, encourage these sales and prevent inventory loading. If sales to ultimate consumers have not taken place, or if participants or recruits otherwise find themselves with inventory they cannot or do not wish to resell, they may return the goods to the company and receive back substantially the same price they paid, less any compensation previously paid on the unsold goods.

In analyzing the propriety of defendant's marketing plan, the Court relies upon the elements of a pyramid scheme as set out in Koscot Interplanetary Inc., 86 F.T.C. 1106 (1975), which found that such schemes are inherently deceptive and in contravention of § 5 of the Federal Trade Commission Act, 15 U.S.C. § 45.[9] See also, In re Ger-Ro-Mar, Inc., 84 F.T.C. 95 (1974), rev'd 518 F.2d 33 (2d Cir. 1974), Holiday Magic Inc., 84 F.T.C. 748 (1974). The FTC's decisions in Koscot, etc. provided a broad definition of unlawful pyramid schemes; the Commission's basic test was that a pyramid rewards recruiting alone "unrelated to the sale of product to ultimate users" through headhunting fees and inventory loading. However, violations of the Koscot standard must be determined using an analysis of whether or not sales of products to ultimate users are taking place and driving the compensation mechanism, and in light of what features exist

[9] Webster, 96 Daily Journal at 2428.

in the plan to prevent the evils of a pyramid scheme. After Koscot, the FTC refined its general analysis in Amway, which has served as the standard for distinguishing bona fide marketing plans from illegal pyramids for nearly twenty years. Many direct selling companies and law enforcement officials have relied on the tests established in Amway.

In Amway, distributors were eligible to receive a monthly bonus which was based on the total amount of products purchased for resale both to consumers and to other distributors. The FTC looked to several features of the Amway marketing plan to determine the legality of such compensation and incentives:

> The Koscot, Ger-Ro-Mar, and Holiday Magic cases all involved "marketing" plans which required a person seeking to become a distributor to pay a large sum of money, either as an entry fee (usually called a "headhunting" fee) or for the purchase of a large amount of nonreturnable inventory (a practice known as "inventory loading") (emphasis added). In exchange, the new distributor obtained the right to recruit others who would themselves have to pay a large sum of money--some of which would go to the recruiting distributor--to join the organization.
>
> By contrast, a person is not required to pay a headhunting fee or buy a large amount of inventory to become an Amway distributor. . . thus a sponsoring distributor receives nothing from the mere act of sponsoring. It is only when the newly recruited distributor begins to make wholesale purchases from his sponsor and sales to consumers, that the sponsor begins to earn money from his recruits' efforts. And Amway has prevented inventory loading at this point with its "buyback rule" which states that a sponsoring distributor shall "[p]urchase back from any of his personally sponsored distributors leaving the business, upon his request, any unused, currently marketable products . . ." Amway, 93 F.T.C. at 715-716.

The Koscot and Amway analyses, together, have set clear standards for determination of whether a plan is a pyramid scheme or a bona fide marketing plan. See, e.g., State ex rel. Miller v. American Professional Marketing, Inc., 382 N.W.2d 117

(Iowa, 1986).[10] A pyramid--in which participants pay for the right to sell a product and receive rewards which are unrelated to sale of products to ultimate users in return for recruiting other participants into the program--is typified by headhunting fees, large up-front payments and inventory loading. A bona fide marketing plan offers significant distinguishing features, like those considered in Amway. Chief among these features is that no fee or compensation is paid merely for having recruited additional participants; no large, non-returnable investment in inventory is required to start or stay in the business; and a commercially reasonable inventory repurchase policy is offered. The Court should be aware of the effectiveness of and reliance which law enforcement, legislators, the public and direct selling companies have placed upon these features and safeguards, particularly the buyback provisions, as clear legal distinctions between bona fide marketing plans and pyramid schemes.

An effective and enforced buyback can eliminate the central ill of a pyramid scheme--inventory loading--by which participants are fettered with inventory they cannot sell and which they purchased in order to receive greater commissions or bonus payments. A buyback eliminates this possibility by ensuring that participants will be able to recoup most or all of their payments for the inventory. Thus, in a bona fide plan, the risk of loss to participants is minimal or nonexistent and the ability to perpetuate a pyramid scheme is effectively nullified.

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[10] In American Professional Marketing, distributors for defendant APMI earned bonuses based on purchases by distributors in their sales organizations. The State alleged that these bonuses were per se illegal under Iowa law. The Iowa Supreme Court disagreed, looking in substantial part to the lack of headhunting fees, inventory loading, and the existence of rules similar to the Amway safeguards.

Pyramids do not offer effective and enforced buybacks. Inventory repurchase policies have, in fact, become the chief mechanism to protect against inventory loading. Two states have recently adopted specific exclusions from their anti-pyramid statutes for companies which have effective buyback provisions similar to that found in Amway.[11] As of 1993, adoption of and adherence to just such a buyback became a condition of membership in the Direct Selling Association. Analysis of the Amway safeguards led the Association to conclude that the buyback was a clear-cut and unequivocal part of the difference between bona fide marketing plans and pyramid schemes. The buyback requirement was specifically adopted and incorporated into the DSA Code of Ethics, a document which already specifically prohibited pyramid schemes. Violation of the DSA Code can result in expulsion from the Association and referral of the matter to law enforcement officials.[12]

Indeed, an effective buyback has become a worldwide standard for prohibiting inventory loading and encouraging sales to ultimate consumers. Several countries have

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[11] See, Tex Bus. & Com. § 17.46(b), and Okla. Stat. Ann. tit. 21, § 1072. Five states and Puerto Rico also have mandatory buyback requirements for multilevel companies. Ga. Code Ann. § 10-1-415(d)(1); La. Admin. Code tit. 16. § III.501; Mass. Ann. Laws ch. 93, § 69(c) (Law Co-op.); Md. Code Ann. Bus. Reg. § 14-302; Wyo. Stat. sec. 40-3-105; P.R. Laws Ann. tit. 10, sec. 997b.a.

[12] The DSA Code of Ethics, §§ 5 and 6, state:

> For the purposes of this Code, pyramid or endless chain schemes shall be considered consumer transactions actionable under this Code. . .
>
> Any member company with a marketing plan that involves selling products directly or indirectly to independent salespersons shall clearly state in its recruiting literature or contract with the independent salespeople that the company will repurchase on reasonable commercial terms currently marketable inventory in the possession of that salesperson and purchased by that salesperson for resale prior to the date of termination of the salesperson's business relationship with the company or its independent salespeople. For purposes of this Code, "reasonable commercial terms" shall include the repurchase of marketable inventory at not less than 90% of the salesperson's original net cost less appropriate set-offs and legal claims, if any.

adopted or are considering adoption of a national law which reflects the Amway buyback safeguard.[13] Similarly, the World Federation of Direct Selling Associations has adopted a worldwide code of ethics which requires adoption of the buyback.[14]

Since Amway, an effective and enforced buyback has been established as the principal standard to distinguish legitimate business activities from pyramid schemes. Likewise, complementary rules similar in purpose and spirit to the 70% and ten customer rules in Amway have since been adopted by a number of companies to help manage inventory and encourage sales to ultimate consumers. These legitimate plans offer rewards based upon distribution of products to real consumers, and all who participate may assess for themselves the demand for their products and whether they will find a sufficient number of consumers to make their efforts profitable. A bona fide plan does not rely upon the large, up-front purchases of inventory of new participants to sustain it. Indeed, legitimate plans offer to repurchase inventory from participants who leave the plan. Plans which offer incentives, such as bonuses based on total purchases of a sales organization, together with the safeguards noted above, are commonplace in the direct

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[13] See, e.g., Competition Act, R.S.C. sec. 55 (1992) (Canada) (excluding companies with buybacks from the definition of a "scheme of pyramid selling"); C. Consumption Art. L. 122-6. 1995 (France) (requiring repurchase of inventory) (expanded upon in Ministere de L'Economie et des Finances, Direction Générale de la Concurrance, de la Consommation et de la Répression des Fraudes, Internal Note No. 6204. 18 Oct. 1995); Law on Retail Trade of 1996, ch. 22, 23 (Spain); Fair Trading Act, 1973, ch. 41; Pyramid Selling Schemes Regulation , 1990, (SI 1989, No. 2195) (England).

[14] The World Federation of Direct Selling Associations (WFDSA) is made up by associations of direct selling companies in 42 countries, representing some 16 million salespeople generating over $63 billion in worldwide sales in 1994. In pertinent part, the WFDSA World Codes of Conduct (Towards Direct Sellers, Between Direct Sellers, and Between Companies) § B.g states:

> On the termination of a Direct Seller's relationship with a company, companies shall buy back any unsold but salable product inventory, including promotional material, sales aids and kits, and credit the Direct Seller's original net cost thereof less a handling charge to the Direct Seller up to 10% of the net purchase price and less any benefit received by the Direct Seller based on the original purchase of the returned goods.

selling industry. Indeed, last year multilevel marketing members of DSA reported sales in excess of an estimated $12 billion retail value in the U.S.

Unfortunately, in reversing the trial court's grant of summary judgment, the Court uses broad language in finding the defendant's compensation plan, on its face, to be a pyramid scheme. DSA's concerns relate primarily to the Court's suggestion that if rewards to participants are calculated based on orders (not actual retail sales) by downline participants, then a sales plan provides rewards "unrelated to the sale of products to the ultimate users" and might thereby be viewed as a pyramid under Koscot. The Court foregoes an initial Amway analysis, and thus could be read to effectively create a presumption which challenges the long-standing and legally accepted practices of many legitimate, bona fide marketing plans.

We believe that this view misconstrues the manner in which the Amway rules approved by the FTC work, would subject legitimate direct selling companies to unworkable recordkeeping and accounting requirements, and confuses the manner in which product and payments flow (and payments are calculated) under a sales plan with the nature of "ultimate rewards" of that plan. Indeed, it is doubtful whether a direct sales plan could function effectively (if at all) if companies or recruiting distributors were required to obtain information about all retail sales of participants. At best, this would involve great practical difficulty with monitoring potentially large sales organizations.

The Court should reconsider its analysis. It is DSA's strongly held view, based on existing legal precedents, that a marketing plan which calculates and pays compensation initially on the volume of inventory purchased by participants and which includes features

to effectively avoid the ills associated with pyramid schemes is, on its face, valid. Reliance on orders and suggested retail prices to calculate rewards is simply a practical and efficient way to calculate the amount of those rewards; it is consistent with, not contrary to, the Amway standards and in no way suggests that the rewards are "unrelated to sales to ultimate users." That determination depends instead on whether a multilevel company has adopted and effectively enforces the Amway or similar safeguards. The burden is on a plaintiff to prove that the rules are not effectively enforced, or that a plan is deceptive. If the Court's language in the case instant were read broadly, it might be construed to effectively shift the burden to the defendants, suggesting henceforth that some companies must as a matter of law prove their legitimacy. The Court should specifically reject this shift of the burden of proof to multilevel marketing companies. We believe it is vital that the Court reexamines its original analysis and affirm the existence and enforcement of the Amway safeguards, particularly the buyback, as clear demarcations between legitimate companies and pyramid schemes as part of any prima facie analysis of the issue.

II. PERSONAL USE OF THE PRODUCTS BY PLAN PARTICIPANTS IS AN IMPORTANT FACET OF MULTILEVEL MARKETING.

The Court's language might be read to misinterpret Koscot to prohibit the sales of products to participants in a multilevel marketing company and to prohibit any payment of compensation on the basis of participant purchases for personal consumption.[15] Any such interpretation would be inappropriate.

[15] "If Koscot is to have any teeth [a sale related to a distributor's use of the products] cannot satisfy the requirement that sales be to ultimate users of a product." Webster, 96 Daily Journal at 2429.

The obvious evil of a pyramid scheme is the defrauding of participants of valuable consideration. Most typically, as in Koscot, participants in an illegal pyramid pay large up-front investments, i.e., recruitment fees, which serve to compensate those higher up in the pyramid scheme. Many recruits ultimately will be unable to recoup those fees. As participation in the plan grows geometrically without any actual demand for the products the plan purports to sell, there is no viable economic engine to drive profits and payments for later-entering participants. Ultimately, the scheme collapses as the pool of available participants diminishes.

By way of contrast, in a legitimate multilevel marketing plan, any product purchased by a participant ultimately must either 1) be sold to another who consumes the product; 2) be consumed by the participant; or 3) be returned to the company. The risk of loss associated with pyramid schemes is simply not present in a legitimate marketing plan, and there is no reason compensation should not be paid based on a participant's total volume of business, including those products which have been consumed by the participants themselves.

Indeed, in DSA's view, the Court may properly take notice that consumption by participants of direct selling companies' products is a natural and appropriate element of direct sales. Many participants in direct selling plans of all types, including multilevel marketing, become interested in the plan only after becoming satisfied consumers of the products they now sell.[16] It is an axiom of direct selling that a company must successfully

[16] Sales to distributors and their use of a plan's products can be crucial to the success of a bona fide direct selling company. The first "customers" for many direct selling companies are their distributors. A 1992 survey of individuals involved in direct selling found that 90.7% of individual direct sellers entered direct selling because they liked and believed in the products. A 1995 industry-wide survey of direct selling companies found that personal consumption by salespeople and their families constituted nearly one third

market its products to its own distributors if it is to have any hope that its distributors will successfully market its products and its opportunity to others.

A bona fide marketing plan does not reward participants for the mere act of recruitment. Instead, as Koscot and Amway demand, it is only when the newly recruited distributor begins to make wholesale purchases from his sponsor or the company, and sales to consumers, that the sponsor begins to earn money from his recruits' sales efforts. See, Amway, 93 F.T.C. at 715-716. It is possible that in pyramid schemes a recruit's inventory purchases may be nothing more than a disguise for recruitment fees. However, in order for the fundamental evil of the pyramid scheme (i.e., defrauding of the participant of consideration paid) to succeed, that inventory purchase must be nonreturnable.[17]

Thus, a bona fide marketing plan whose participants make personal purchases and use of the product and are insulated from the possibility of substantial loss by the plan's inventory repurchase policy, does not violate Koscot. Statutory enactments have recognized as much.[18] It must be left to the trier of fact to determine whether, in reality, a plan's buyback is enforced and effective in preventing the possibility of substantial loss.

In light of the fundamental marketing realities of the direct selling industry[19] the desires of its salespeople, and the ample protections which exist to prevent the pyramid

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of 1994 retail direct sales by direct selling companies. 1995 Direct Selling Industry-Wide Growth and Outlook Survey; 1992 Direct Selling Association Survey of Direct Sellers.

[17] See, Amway, at 715.

[18] See, Tex. Bus. & Com. § 17.46(b), and Okla. Stat. Ann. tit. 21, § 1072.

[19] See, Thomas R. Wotruba, Direct Selling Education Foundation, Moral Suasion, Development of the US Direct Selling Association Industry Code of Ethics (1995); Special Issue on Direct Selling, in J. of Marketing Channels (Bert Rosenbloom ed., Feb. 1993); Wotruba, "Full-time vs. Part-Time Salespeople - A Comparison on Job Satisfaction, Performance and Turnover in Direct Selling," Int'l. J. of Research in Marketing, Issue 7 (1990); Wotruba, "The Effect of Goal-Setting on the Performance of Independent Sales Agents in Direct Selling," IX The J. of Personal Sales & Sales Mgm't. (Spring 1990); Robert A. Peterson, et al., "Research Note: Consumers Who Buy From Direct Sales Companies," 65 J. of Retailing (Summer 1989).

evil of inventory loading, DSA urges that the Court should not use any analysis which could be misconstrued to prohibit distributor use of product or compensation based on distributor purchases.

CONCLUSION

DSA supports full and effective enforcement of the Amway standards to prevent pyramid sales organizations and recognizes that enforcement, not just adoption, of the Amway or similar standards is necessary to achieve that goal.

As the Court considers this case further, DSA urges it to do so in language that does not inadvertently and improperly undermine DSA members' ability to rely on reasonable standards, such as those in Amway. This will require recognition that the Amway standards may be satisfied, and rewards under the sales plan will remain "related to the sale of product to ultimate users," even if compensation or rewards to distributors are not calculated or based solely on actual retail sales. It will also require recognition that the Amway standards may be satisfied when rules (e.g., buyback, 70%, 10 retail customer, etc.) have the combined effect of avoiding compensation based solely on recruiting and of promoting and maintaining the sale of products to ultimate consumers. As authorities throughout the country and world now recognize, this is particularly true of an effective buyback rule, a key factor differentiating between a bona fide marketing plan and an illegal pyramid scheme.

DSA urges that any decision issued by the Court on this appeal avoid language which could be read to effectively shift the burden of proof to multilevel marketing companies, which have the protective characteristics described in Amway, to establish that

they are legitimate. Plaintiffs must have the burden of establishing wrongdoing on the part of an alleged pyramid scheme. Further, the Court should recognize the procedural posture of the case and avoid any findings which could be construed to interpret or apply the Amway standards outside the context and limited record of this case.

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