

LOTTERIES:
REFERRAL SELLING:

Referral selling operation described herein in which the purchaser participant is involved in earning some of his commissions through the enrollment of other purchasers is nevertheless a lottery.

OPINION NO. 195

May 15, 1969



Honorable John Crow
Prosecuting Attorney
Greene County
Court House
Springfield, Missouri 65802

Dear Mr. Crow:

This is in response to your request of March 19, 1969, for an opinion from this office concerning referral selling. Specifically, you wish to know whether referral selling as is described below:

1. Is a lottery under the provisions of Sections 563.430 and 563.440, RSMo Supp. 1967.

The specific referral selling scheme to which the opinion request referred differs from the usual referral selling scheme by virtue of the participation of the purchasers. Initially, the buyer is brought to a meeting by a salesman of the seller or a friend who has, himself, become involved in the referral selling scheme. He is induced there to purchase an item at an amount greater than its retail price, and to pay an additional sum to become either a "founder distributor" or a "founder supervisor" for the referral seller. The purchase of the item by this "founder" is incidental to his role as founder and the inducement for the purchase is not the value of or the need for the item, but the opportunity to make a substantial amount of money by becoming a founder.

The referral seller promises to build or otherwise establish a "market center" in the area at which the merchandise will be sold to persons holding special "purchase authority cards" only. This center will be built within sixty days after one hundred percent of the founders provided for (no more than two-thirds of one percent of the total population of a trade area, or five thousand persons, whichever is smaller) are enrolled. A "trade area" is defined in the founder purchase contract as encompassing "a seventy-five mile

Honorable John Crow

radius of any city or town chosen, and at [the seller's] option, may be a smaller geographic area." However, the trade area may not be smaller than one with a population large enough to permit the enrollment of two thousand founders and distribution of one hundred thousand purchase authority cards. If fewer than one hundred percent of the founders planned for are enrolled, the center will be built, only it will be a smaller facility. There is no promise that the center will be built within any specified time, however.

Purchasers brought into this referral selling operation may enroll as either founder "distributors" or founder "supervisors." A founder distributor must purchase either a tape recorder or a set of cookware for \$150.00, of which \$60.00 is commission and \$90.00 is purchase price. A founder supervisor must purchase either a color television set or a music center for \$750.00, of which \$450.00 is commission ("training fee").

A founder distributor receives fifty "purchase authority cards" for distribution to potential customers of the seller's market center. On each sale to a person holding a card distributed by him, the distributor receives a commission of four percent, subject to a deduction of five cents for each card distributed to him per month in any quarter in which anyone of those cards was used for a purchase at the market center. In addition to this, and by far the major inducement to persons who are asked to become founders, a distributor receives \$50.00 for every founder distributor and \$100.00 for every founder supervisor whom he presents for enrollment. If a founder distributor becomes a founder supervisor (through another purchase for \$210.00 and a \$390.00 "training fee"), the distributor who enrolled him receives an added commission of \$50.00. For every ten founders he enrolls, a distributor receives an added ten purchase authority cards for distribution. The founder distributor is required by the contract he signs to encourage purchase authority cardholders to purchase merchandise at the seller's center. If a purchase authority cardholder does not make purchases for two consecutive quarters, the distributor must seek to redistribute that holder's card to another person. The seller engages that he will send such distributor reports quarterly as to the number of purchases made by persons holding cards distributed by that founder.

A founder "supervisor" receives fifty purchase authority cards for distribution, and he earns a five percent commission on each purchase made with such a card (subject to the same five cent deduction described above). For each distributor he causes to be enrolled, the supervisor receives a commission of \$60.00, and for every supervisor he causes to be enrolled, he receives \$450.00. If a distributor enrolled by this supervisor himself enrolls a

Honorable John Crow

distributor, the supervisor receives a commission of \$10.00 for the enrollment of this "indirect" founder. And, if that indirect distributor upgrades himself to a supervisor, the original supervisor receives another \$340.00. The supervisor also receives \$390.00 for every direct distributor whom he enrolled who becomes a supervisor. For sales made by the use of purchase authority cards issued by distributors whom he enrolled, the supervisor receives an amount equal to twenty-five percent of the commissions earned on such sales by "his" distributors.

There is no limit on the number of supervisors who might be enrolled in this program other than the total limit on the number of founders. Conceivably, all distributors may become supervisors. While supervisors are required to attend sales meetings and training sessions, if such are held (there is no obligation on the part of the seller to hold any), and to exhort the distributors "in his sales organization" to greater efforts in encouraging the use of purchase authority cards and the enrollment of founders, the supervisor has no supervisory authority over "his" distributors. While he is to have sales meetings, "his" distributors are not obliged to attend. The supervisor is given reports on the purchases made by holders of purchase authority cards distributed by him and by "his" distributors.

The referral seller supplies all promotional aids to the founders and aids them in enrolling other founders. The actual sale and enrollment process is performed at a meeting to which the founders bring their friends and other prospects. The sales pitch is based on the opportunity to earn money rather than on the value of the items to be sold. The founder is instructed to participate in the process by which his prospect is persuaded to enroll; and, in fact, the founder himself takes on the initial job of persuading his prospect to make the purchase and become a founder.

I. IS THIS A LOTTERY?

While the laws of Missouri do not define the term, "lottery," both statute and constitutional provisions prohibit it. Missouri Constitution, Article III, Section 39 (9); Section 563.430, RSMo Supp. 1967. However, the term has received a judicial gloss from the Missouri courts, and has been the subject of opinions of this office. Generally, a lottery is a device whereby a person is offered a chance to receive great gain in exchange for some consideration. The Supreme Court of Missouri said, in State ex inf. McKittrick vs. Globe-Democrat Publishing Company, 341 Mo. 862, 110 S.W.2d 705 (1937), that a lottery has three elements: consideration, prize, and chance. In view of the constitutional status of Missouri's prohibition of lotteries, these elements should be applied broadly to fulfill the apparent purpose of the prohibition. For example, in State vs. McEwan,

Honorable John Crow

343 Mo. 213, 120 S.W.2d 1098 (1938), the court held that a "bank night" was within the definition of "lottery" even though persons could register and qualify for prizes without actually purchasing a ticket to the movie house which held the "bank night." Consideration existed as a practical matter, the court held, because a person had to be present to claim his prize and make the claim within two and a half minutes after his name was drawn, and because the drawings might be held inside the theater as well as outside. Moreover, the inducement to buy a ticket to see the movie was quite strong to the person who was present for the drawing.

There is little doubt that there is consideration in the referral selling operation described above. Under the McEwan rationale, had the referral selling plan required merely that the purchaser "founder" pay the actual retail price of the goods purchased as a condition to participation in the plan, the requisite consideration would have been present. In McEwan, supra, the most a person would have had to pay was the regular price of a ticket to enter the theater and see the movie. See also State vs. Mumford, 73 Mo. 647 (1881). Here, the founder pays a sum in addition to the retail price of an article he purchases; this sum is an added consideration for participation in the referral scheme.

Moreover, the referral selling scheme clearly involves a prize. Again, Missouri's courts have construed this term most liberally. See, e.g., State ex rel. Home Planners Depositary vs. Hughes, 299 Mo. 529, 253 S.W. 229 (1923) calling the offering of below-market interests rates to participants in a lending plan sufficient to constitute the offering of a prize. It would seem certain in the light of Hughes that any plan whereby a person is offered the chance to make large amounts of money over and above his payment for that opportunity, involves the offer of a prize. While the participant "founder" does extend some effort in obtaining the prize, such effort is not determinative for this purpose. In State ex inf. McKittrick vs. Globe-Democrat Publishing Company, supra, the prize depended upon substantial effort in the solution of difficult rebus puzzles. It was held nevertheless that a prize was involved.

It is more difficult to find that this referral selling scheme involves an element of chance sufficient to label it a lottery. Again, the Globe-Democrat case, supra, supplies the necessary standard. In that case the defendant publishing company published a series of cartoons which were to be interpreted to arrive at "famous names." The cartoons include persons, things, and words. The contestant was to "solve" the cartoon rebus by finding in it the parts of a word or set of words which made up a famous name. The initial set of cartoons was found to be rather simple, but subsequent sets became more and more difficult. It was found by the trial court that a great amount of skill was needed in the solution of these

Honorable John Crow

puzzles, but that sometimes an accurate guess was enough. Moreover, it was found that some of the most difficult puzzles were somewhat ambiguous--they could give rise to two or more different solutions of which one was supposedly "preferred." Hence, although it was minor as a quantitative matter, guess work and blind luck could give one person success and eliminate a substantial number of other contestants. The court held that this was sufficiently invested with the element of chance to be a lottery.

" . . .the fact that skill alone will bring contestants to a correct solution of a greater part of the problems does not make the contest any the less a lottery if chance enters into the solution of another lesser part of the problems and thereby proximately influences the final result. In other words, the rule that chance must be the dominant factor is to be taken in a qualitative or causative sense rather than in a quantitative sense. . . ." (110 S.W.2d at 717)

In another case, State ex rel. vs. Hughes, supra, chance is seen as involving uncertainty with respect to the actual realization of the promised reward without any reasonable way in which to determine the probabilities of such realization. 253 S.W. at 231.

In other states, referral selling schemes have been held to be lotteries because they involve a substantial element of chance. However, in all of these cases, the customer was promised commissions only if a salesman of the seller contacted and sold the seller's products to (and in some cases enrolled as a "representative") the persons' whose names the customer supplied. It was not certain that the company's salesman would even contact these persons, nor was it clear that the salesman would represent the seller's product in an adequately persuasive manner to make the sale if, in fact, he did make the contacts. Skill or judgment on the part of the customer in selecting the names was not a predominant contributing factor in determining whether or not that customer would receive commissions. Sherwood and Roberts--Yakima, Inc., vs. Leach, 67 Wash.2d 630, 409 P.2d 160 (1966); Commonwealth vs. Allen, 404 S.W.2d 464 (Ky. 1966); Commonwealth vs. Campbell, 406 S.W.2d 730 (Ky. 1966); State vs. ITM, Inc., 52 Misc.2d 39, 275 N.Y.S.2d 303 (Usp. Ct. 1966); M. Lippincott Mortgage Investment Co. of Florida vs. Childress, 204 So.2d 919 (Fla. Dist. Ct. App. 1967).

Similar referral selling schemes, again involving minimal participation on the part of the referral customer in the "earning" of promised commissions were deemed not to be lotteries in Ohio.

Honorable John Crow

DeWitt Motor Company vs. Bodnark, 14 Ohio Op.2d 25, 169 N.E.2d 660 (Com. Pls. 1960) (dictum); Yoder vs. So-Soft of Ohio, Inc., 30 Ohio Op.2d 566, 202 N.E.2d 329 (Com. Pls. 1963) (The court held that the referral sales contract was a security, however); First Discount Corp. vs. Cua, 117 Ohio App. 105, 190 N.E.2d 695 (Ohio Ct. App. 1962). The Oklahoma Supreme Court also held the referral selling scheme not to be a lottery on the basis of a very close and highly technical reading of Oklahoma's lotteries statute. The statutes included referral selling schemes in which the purchaser "agrees" to secure future purchasers. There being no actual agreement so to do on the part of the referral buyer, there was no lottery. Krehbiel vs. State, 378 P.2d 768 (Okla. 1963); A. A. Murphy, Inc., vs. Taylor, 383 P.2d 648 (Okla. 1963). The major difference between the Washington, Florida, and Kentucky decisions, and the decisions of the Ohio courts is on their evaluation of the element of chance. The Ohio court in First Discount Corp. vs. Cua, supra, noted that "An element of chance permeates most of the affairs of men. . . ." and found that ". . .The analogy between the commissions provided in this agreement and the perfectly lawful overwriting commissions of the general agent, jobber, etc., on the sales of his subordinates, is a valid one, even though the representative here must depend upon persuasion alone without actual authority." (190 N.E.2d at 697).

In an opinion of this office issued on February 6, 1963 (No. 86), the rationale of the Sherwood and Roberts--Yakima, Inc. case and the cases following it was implicitly accepted and that of the DeWitt case and the subsequent Ohio cases was rejected. It was there that the element of chance adhered in the absence of control on the part of the buyer over the attainment of his commissions.

There was another feature of referral selling plans which was mentioned in the above opinion of this office and in the opinion of the court in Sherwood and Roberts--Yakima, Inc., supra, the referral buyer has no way of knowing the extent to which the market for the items sold is saturated. The multi-level and unlimited scope of the referral selling scheme made it impossible, at some point unknown to the buyer, for the buyer to recoup his investments much less make any profit. This "chance" feature inheres in and at some point in the proliferation of referral buyers, dominates the plan. Such domination by "chance" would occur whether or not the participants in the plan were expected to and did participate in the actual earning of their commissions. If a referral buyer enters into a referral selling plan without knowing or being able to know how many participants were already enrolled, and without any means by which a person experienced in the trade could test the remaining market and estimate his chance for success, he is relying more on luck than on skill to help him make his money.

Honorable John Crow

In State ex rel. vs. Hughes, 299 Mo. 529, 253 S.W. 229 (1923), this "chance" feature became part of the Missouri's definition of "lotteries." In that case, a person was given the opportunity to borrow money from a certain fund at below-market interests up to the face value of a certificate which he had to purchase. The certificate costs the holder \$4.00 per month for every \$500.00 of the face value. Paid up certificate holders could cash in their certificates for the face value plus a certain amount of earnings. Each certificate holder was allowed to borrow money in the order in which his application for certificate was made--down to the day, hour, and minute. Hence, his opportunity to borrow any substantial sum at the low interest rate depended in large part on the number of certificate holders who were eligible to and did borrow money from the fund beforehand. Holding this sufficient to import a dominating element of chance into the plan, the court said:

"It is manifest that the subscriber, while he knows the 'day, hour, and minute' his application for the certificate is made, cannot know the number of certificates which have been applied for preceding his application. Even if he knew the actual number which had reached the fiscal agency and had been listed, he could not know how many applications had been taken thereafter by relator's representatives and had not reached the office for listing. It follows he cannot know his rank or order in the matter of eligibility for a loan. . . . The value of his certificate depends in part upon the order in which it becomes eligible for a loan, . . ." (253 S.W. at 230-231)

The referral selling plan, with which this opinion is concerned, contains both the elements of chance found in the Hughes case and that found in the Washington, Kentucky, and Florida decisions discussed above whose reasoning is adopted by implication in the above official opinion issued by this office in 1963. The number of probable founders is limited to a percentage of the population in the trade area to be served by the seller's market center. This limits the risk on the part of each founder that the number of persons who might receive and use the purchase authority cards might be insufficient. On the other hand, as the number of founders grows in any given market area, the additional number of founders who may be enrolled decreases. Each subsequent enrollee is thus limited in the number of commissions which he might earn for the enrollment of other founders. There is apparently no way for the prospective founders to know (1) how many other founders have been enrolled in the area, or (2) how many founders are being enrolled and are being

Honorable John Crow

solicited now. That is, he has no way of ascertaining the possible market from which he expects to make his largest commission--the market for enrollees. Moreover, his ability in the future to enroll founders depends in a negative way directly upon the unforeseeable and uncontrollable (by him) ability of other founders to enroll founders. Not only the Hughes case, but also Sherwood and Roberts--Yakima, Inc. vs. Leach, supra, would serve as authority for the primacy of the chance feature here.

Chance is even more apparent when one considers the commissions earned by supervisors and commissions accruing from the change of status from distributor to supervisor. A supervisor has relatively little to say about what distributors in his "sales organization" do with their time. He has no coercive authority with regard to hiring and firing, either directly or indirectly, through reports to the seller concerning the distributor's behavior. While the distributor is obligated to use reasonable efforts to encourage purchase authority cardholders to make purchases, such obligation does not extend to the enrollment of founders. Moreover, such obligation as exists to serve the seller's interest is subject to the distributor's and supervisor's right to engage in other gainful employment. (See Master Founder Purchase Contract, paragraphs 11 and 13). The most a supervisor can do is exhort and persuade at sales meetings (at which attendance is apparently not required of distributors). Yet, a supervisor receives a commission, not only for founders which he enrolls, but also for founders which "his" distributors enroll. Moreover, a supervisor receives a commission (as does a distributor) for every founder whom he enrolled who becomes a supervisor; and, in addition, he receives a commission for every distributor who was enrolled by one of his distributors who becomes a supervisor. Unless the amount of his commissions warrant his spending a substantial amount of time on the job as supervisor (and hence away from his regular employment if such exists), it is highly doubtful that his efforts contribute to the enrollment of these indirect distributors or their elevation to supervisor. Since there is no limit to the number of distributors who become supervisors, the supervisor's commissions on the enrollment of indirect distributors and on sales made on purchase authority cards by "his" distributors is, therefore, also highly contingent on decisions made independently of his efforts.

Another source of commissions for founders is sales made to holders of purchase authority cards. It is the duty of each supervisor to encourage distributors to encourage holders of these cards to make purchases. The market center at which these purchases are to be made is not yet built. The quality of merchandise offered there and the salesmanship of the persons working at the center is still unknown. Much depends upon these two factors to determine

Honorable John Crow

the amount of money received by distributors and supervisors from sales at the market center, yet supervisors are given a twenty-five percent override on commissions earned by distributors from such sales. A supervisor is also given a commission of five percent of the sales made to holders of purchase authority cards which he distributed. Distributors receive a commission of four percent on such sales made to holders of cards distributed by them.

Distributors are encouraged to redistribute cards which are not used in any two quarter period (and we shall assume that cards remain the property of the seller in order to facilitate redistribution). Information concerning the use of purchase authority cards is given to the supervisor and distributors working in his "sales organization" to enable them to determine what effort is required to increase sales to holders of these cards. However, the number of actual purchases and the size of each purchase must depend upon the quality of the market center and its competitive position in the trade area. Moreover, the size of the commissions (subject to the five percent per card service charge) is sufficiently low to make any great sales effort on the part of the founder appear relatively unrealistic. Assuming that a distributor has distributed fifty purchase authority cards, and the holders of these cards make purchases at the market center averaging each \$100.00 per month, the distributor's commission would be \$200.00 per month less a monthly service charge of \$2.50. Yet the return from a single cardholder's purchases would only be \$4.00 per month. Thus, as a practical matter, chance is a dominate feature in the rewards accruing to the distributor from the actions of the cardholders.

The present inducement for enrollment of founders is clearly not the relatively minor earnings from sales to purchase authority cardholders at a market center not yet built. More clearly, the major inducement must be the opportunity to earn substantial commissions from the enrollment of other founders. As was suggested above, the chance factor in this aspect of the plan is quite clear and becomes even more clear as the number of enrolled founders increases.

The referral selling scheme, with which this opinion is concerned, does indeed come close to what might be characterized as the sale of a business opportunity. When a person buys a business, he is purchasing a chance to exploit it and profit from it in the future. His success or failure depends in large measure upon events in the future, and upon circumstances in large part beyond his control. A person entering into such a transaction nevertheless has or is an experienced businessman, can acquire information concerning present competition and market conditions, and can make certain assumptions about what will happen in the near future which will be fairly accurate. The kind of information on which similar relevant judgments are based is not available to the person enrolling

Honorable John Crow

as a founder. Moreover, the involvement or expected involvement of the purchaser of a business opportunity with a profitable operation of the business is of a far more intense and otherwise different nature than that of the founder with the earnings of commissions either from enrollment of other founders or from sales made to holders of purchase authority cards. While the kind of referral selling operation discussed here comes close, it does not appear to be the equivalent of such a legitimate transaction.

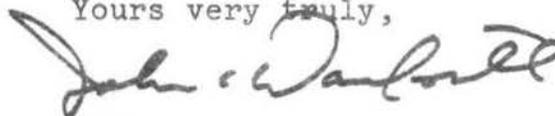
As was stated above, the constitutional status of Missouri's prohibition of lotteries urges a broad and effective interpretation of the elements which comprise a lottery: consideration, prize, and chance. As State vs. McEwan, supra, pointed out, the practical effect of a scheme or plan may be taken into account in determining whether the damning features are present. Moreover, the qualitative focus of State v. Globe-Democrat Publishing Company, supra, and the breadth of the definition of chance in State ex rel. vs. Hughes, supra, strongly suggest the dominance of the chance factors in the referral selling operation described in this opinion. As was noted, the element of chance is strongly present even in the area of commission earnings in which the founder purchasers are most directly involved--the recruiting and enrollment of other founders. For these reasons, it is the opinion of this office that the referral selling scheme described in this opinion is a lottery within the provisions of Sections 563.430 and 563.440, RSMo Supp. 1967.

CONCLUSION

It is the opinion of this office that the referral selling operation in which founder purchasers are promised commissions from the enrollment of other founder purchasers by them and from sales made to persons holding purchase authority cards distributed by such founders, or by persons within such founders' "sales organizations," in a market center yet to be built, is a lottery within the provisions of Sections 563.430 and 563.440, RSMo Supp. 1967.

The foregoing opinion, which I hereby approve, was prepared by my Assistant, Dennis J. Tuchler.

Yours very truly,



JOHN C. DANFORTH
Attorney General

Enclosure: Op. No. 86, Reardon,
2-6-63