

LOTTERIES:  
SALES:  
REFERRAL SELLING:

Plan whereby buyer of merchandise receives commission on each purchase by persons to whom he refers salesman is a lottery.

February 6, 1963

OPINION NO. 86

Honorable Daniel P. Reardon, Jr.  
Circuit Attorney  
City of St. Louis  
Municipal Courts Building  
St. Louis, Missouri

Dear Mr. Reardon:

This is in response to your request for an opinion of this office which request reads as follows:

"Our office has received a series of complaints from the Better Business Bureau and from private individuals relative to a scheme called "Referral Selling." I have enclosed photostats of portions of our file to give an indication of the scope of the problem.

"The general tenor of the complaint is as follows: The business in question will have their salesman contact a customer to sell a product. As part of the inducement to buy, the customer will be told that if he would submit the names of twenty close friends and write a letter of introduction for the salesman to these friends, six of these twenty will subsequently be chosen by the salesman for future contacts. For each contact that is made, allowing the salesman to make a demonstration of his product or simply to outline his program, the original customer will receive a gratuity. If a sale is made, a further gratuity will be made. Also, the customer who had originally referred the salesman to his present contact would receive a gratuity, if this present contact makes a purchase. The sum of the gratuities to be received, if all

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goes right, usually exceeds the purchase price; and these gratuities are frequently promised to continue into several rounds of subsequent sales. You will notice in the enclosures that there is a detailed complaint of this type of situation.

"Based upon this hypothetical set of facts, we wish to formally request of the Attorney General his legal opinion as to whether or not the scheme as elicited and popularly called 'Referral Selling' would constitute a lottery according to the existing Missouri Statutes on the subject."

Within the past few months, this office has received many complaints similar to those attached to your inquiry. The merchandise being sold by such methods may be water softeners, stereophonic record players, automobiles, or home fire alarm systems, but there are several elements which, on the basis of our experience and as confirmed by the attachments to your letter, seem to be common to all such schemes:

1. The seller de-emphasizes the fact that the transaction is a sale, frequently initiating his contact with prospective buyers by telling the latter that they are going into the "advertising business" together. The prospective buyer is then told how he will make large sums of money which will more than pay for the item he purchases as he receives his commission from the sales made to prospects to which he refers the seller. These commissions, it is often promised, will continue into the second, third, or even fourth "generation" of sales. In fact, the buyer seldom receives any of the promised commissions and, as far as we can determine, a buyer has yet to receive more money from such a transaction than he is required to pay out for the merchandise.

2. The second element common to virtually every one of these schemes is the almost immediate negotiation of

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the promissory note signed by the buyer. This transaction, consummated rapidly, then leaves the buyer facing a "bona fide purchaser" of the note whose rights under the note are not contingent upon the success or failure of the "advertising venture". In some cases of this nature, the obligation of the buyer is secured by a mortgage on his home which gives even additional leverage to the "bona fide purchaser" in his subsequent dealings with the erstwhile "advertiser".

3. In many of these schemes, the seller either leaves the locality after making several hundred sales or the seller declares bankruptcy. In either event, his buyers are then left with no hope of ever recouping any of their investment through commissions on referral sales because there is no one to do the selling and no merchandise to be sold.

4. The merchandise sold by these tactics is often of inferior quality and greatly overpriced. When finance charges, by whatever name they may be called in the promissory note, are added, the disparity between price and value received frequently becomes tragically ludicrous. Unfortunately, the lack of quality in the merchandise frequently does not become apparent until after the buyer assumes his obligation to pay since the sales are customarily made from catalogues with no opportunity for inspection of the merchandise. One group of operators promoting a scheme of this kind sold a line of large electrical appliances labeled with a nationally known brand name. The appliances were not, in fact, products of the nationally known manufacturer but low-quality "counterfeits" produced by a little known firm.

Turning now to your question whether schemes of this type are lotteries, we note that our Supreme Court has held "that a lottery includes every scheme or device whereby anything of value is for a consideration allotted by chance." State v. Emerson, (Mo. Sup. 1927) 1 SW2d 109, 111. In State ex inf. McKittrick v. Globe-Democrat Publishing Company, (Mo. Sup. 1937) 110 SW2d 705, 713, the Court said simply, "The elements of a lottery are: (1) Consideration; (2) prize; (3) chance."

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Although lotteries are condemned by the constitution of this state, Constitution of 1945, Article III, Section 39 (9) and although their establishment is deemed a felony by statute, Section 563.430, RSMo 1959, we have no statutory declaration that a scheme of the specific type we are considering here is a lottery. In the absence of a clear statement by the Legislature to that effect, it will be necessary to measure the facts of the typical referral selling plan against the above quoted definitions of the term "lottery".

CONSIDERATION: In all plans of this type, the customer "buys" something, be it an automatic fire alarm system or an electric coffee maker, in the sense that he gives a promissory note in exchange for the merchandise. Value of the note is attested to by the fact of its negotiation and, in many cases, its subsequent enforcement. Even if the merchandise can be regarded as a fair exchange for the amount of the note, the purchase price will still constitute the "consideration" necessary to the existence of a lottery. Hence, in State v. McEwan, (Mo. Sup. 1938) 120 SW2d 1098, 1100, it was of no import that persons purchasing a theater ticket were permitted to view a moving picture in addition to having an opportunity to win the "bank night" drawing. Quoting with approval from a decision in another jurisdiction, our Supreme Court said, 1.c. 1100:

"It is idle to say that the payment made for seeing the picture is not, in part at least, a charge for the drawing and the chance given. The things to be seen and done in the theater and the privileges above enumerated which accompanied them, are all a part of one and the same show, meaning the entire proceedings inside the theater. The fact that part of the things to be enjoyed by those who paid at the door were classed as 'free' by the defendant in error does not change the legal effect of the transaction, or what was

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actually done by defendant in error, namely, for the price of admission to grant the patron not only the opportunity to see and hear the picture, but to see and hear and enjoy the habiliments of the 'Bank Night,' drawing, etc., detailed above."

Likewise, the Court ruled in *State ex rel. Home Planners Depository v. Hughes* (Mo. Sup. 1923) 253 SW 229, 230, that the scheme described therein was a lottery, stating that "The fact that each certificate holder eventually might or would receive an amount equal to the aggregate of his payments can make no difference if, in addition, each secured a chance for a prize." See also *State v. Emerson*, (Mo. Sup. 1927) 1 SW2d 109, in which a scheme was declared a lottery wherein participants making weekly payments of \$1.00 each would obtain \$55.00 worth of furniture after paying that amount or, if selected by the furniture company prior to the fifty-fifth installment, they would receive \$55.00 worth of furniture for the amount they had paid to date. A similar plan involving suits of clothes was held to be a lottery in *State v. Meyer Tailoring Co.*, (Mo. Sup. 1929) 25 SW2d 98, in spite of the \$45.00 limitation on the amount to be paid in by weekly installments and the fact that each participant would obtain a suit of clothes presumably of that value regardless of whether he paid the full \$45.00 or was previously relieved of making further payments by being arbitrarily selected by the company as a recipient of its favors.

PRIZE: The element of prize is readily apparent in the referral selling schemes discussed above: The participant is to receive a stated amount of money for each "lead" he furnishes to the seller which results in a sale. As indicated in your letter, some plans of this nature include an arrangement whereby a certain commission is paid to the participant whenever any of the "contacts" provided by him merely sit through the demonstration and sales pitch. In many cases, a commission is promised to the original participant for each sale made to the "leads"

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furnished by those purchasing as a result of the salesman's being referred to them by the original participant. Hence, such plans are said to benefit the original participant into the second, third, or fourth "generation" of sales.

At the very least, participants are promised that they will recoup the amount of the purchase price and are frequently induced to enter the "advertising" plan on the assurance that it will be a source of extra income, over and above what is necessary for payments to the finance company, into the indefinite future.

As in State ex inf. McKittrick v. Globe-Democrat Pub. Co., (Mo. Sup. 1937) 110 SW2d 705, 717, this is "an opportunity . . . to gain some 'easy money'." A better example of the element of "prize" could hardly be imagined.

CHANCE: Somewhat more elusive in the referral selling schemes is the element of chance. However, for the reasons hereinafter stated, we are of the opinion that this element is inherent in the plans.

The scheme you outlined in your letter mentions twenty referrals from whom six will be selected by the seller for the same special treatment that the buyer is getting. Other plans utilize different numbers, but the pattern is generally the same. Ignoring the fourteen who are not selected for participation in the advertising plan and starting from a basic number of six who must buy in order for the promises to the initial participant to be fulfilled, we find that the second "generation" of buyers will involve thirty-six persons. In order for the plan to be consummated as to them and for the commissions to continue as promised to the initial participant, the salesman must then persuade 216 persons to enter into the program. The number of sales that must be made in succeeding rounds for the plan to continue to reward the participants is as follows:

Fourth Round:	1,296
Fifth Round:	7,776
Sixth Round:	46,656
Seventh Round:	279,936
Eighth Round:	1,679,616
Ninth Round:	10,077,696
Tenth Round:	60,466,176

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Examination of the foregoing figures reveals the practical impossibility of fulfillment of the promises made to the individual participants. For the plan to work as represented by the seller, at some point prior to completion of the eighth round a number of new sales equal to the entire population of the City of St. Louis would have to be made. In order for the plan to continue successfully through the tenth round, new sales would have to be made to a number roughly equivalent to twice the entire population of Missouri, Illinois, Iowa, Kansas, Arkansas, Tennessee and Kentucky. And this is exclusive of any consideration of the astronomical number of persons who would already be participating in the program.

Moreover, many such plans start from a basic number of twenty or even thirty sales, rather than the six mentioned above, in the first round. In such cases, the progression is obviously much more rapid.

Considered in this light, some plans might well be said to possess the element of chance as they progress through their more advanced stages. The saturation which is the necessary effect of the operation of such plans might, at some point, make it a matter of the purest chance for a person to be found who was not already participating. Under these circumstances, the element of chance might be provided by the saturation aspect alone. However, in the instant case, other factors are present which make this determination unnecessary.

Rather, we believe that the element of chance is provided by the complete absence of any control on the part of the buyer over the operation of the plan after he signs the promissory note. For example, it is the salesman that selects the six names of prospective participants from the twenty names submitted, if, indeed, a selection is made. Whether the prospects, if a selection is made, are ever contacted is up to the salesman, not the person who has submitted the names. Whether the prospects submit to sitting through the sales talk or demonstration and whether they ultimately buy whatever merchandise may be involved are matters totally beyond the control of the original buyer.

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The uncertainty is multiplied as the scheme progresses into subsequent "generations", for the original participant's success is then made to depend not only upon the acts of the salesman with regard to the participant's list of names, but also upon whether or not lists are submitted by subsequent buyers. The probability that the plan will develop as represented is then a matter completely out of the hands of the initial participant and totally subject to the whims and caprices of agencies beyond his control.

It is this uncertainty concerning the acts of others and the lack of control over subsequent events which, we believe, supplies the necessary element of chance. In *State v. Hughes*, supra, wherein the prize was the early allotment of a low-interest loan from an unincorporated association, our Supreme Court found that the element of chance inhered in the impossibility of the participant to know when the money for his loan would become available. At page 231, the Court said:

"The uncertainty in respect to the order in which the certificate will become eligible for a loan is the thing which introduces the element of chance into the plan of distribution. It cannot be resolved by reason or on probabilities, but depends upon conditions such that the applicant cannot know when he signs whether many or few applicants are ahead of him and whether, therefore, he is to receive a loan early or late."

It is submitted that the same type of uncertainty exists in the instant case, for it is equally impossible for a participant in a referral selling scheme to know whether the salesman will actually attempt to sell to the persons on his list, whether any sales will be made, whether subsequent purchasers will cooperate by providing further references, or whether such references will spawn further sales.

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Such dependency upon acts of others over whom the participant had no control was held in *New v. Tribond Sales Company*, (C.A., Distr. of Columbia, 1927) 19 F.2d 671, to supply the necessary element of chance in constituting a referral selling scheme a lottery where the Court said, l.c. 674:

"It is apparent, we think, from what we have said, that whether a 'contract' holder will get his hosiery for an investment of \$1, \$5, \$8, or \$10, depends upon contingencies largely beyond his control. First, there is the requirement that the three 'respective purchasers' to whom he sells the three coupons will in turn remit \$3 each to the corporation for three other 'contracts.' These coupon purchasers may, upon inquiry, ascertain that others are trying to sell coupons, and they may, for this or some other reason satisfactory to them, conclude to forfeit the \$1 paid for the coupon and abandon the scheme. Obviously this is a matter beyond the control of the original 'receipt holder,' and, as to him, a matter of chance. \* \* \*"

Moreover, the classic "endless chain" scheme has been denominated a lottery by many courts, including the Supreme Court of the United States, for the same reason. The "endless chain" scheme is one which may be spread by letter or by word of mouth. Under usual terms of such a plan, a participant accepts a list containing a number of names from an earlier player. The new participant is required to give or send some consideration (which may be a savings bond, a ten dollar bill, or a ten cent piece) to the name which appears on the top of his list. This top name is then stricken from the list, and the new participant makes up a number of new lists equal to the number of names on the old. In the new lists, the name that was in the second position is advanced to the top position and the new participant's name is inserted at the bottom.

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The new participant then recruits new members, each of whom is given a list and each of whom passes on the required consideration to the name on top of the lists. The new recruits then advance all names one notch after striking the name on the top and insert their names on the bottom. At this point, the name of the first participant mentioned above advances to the second position from the bottom. The plan progresses with a type of saturation similar to that discussed above. If all subsequent participants perform as the first, preparing and distributing lists, his name will ultimately appear as the first name on hundreds or thousands of lists (depending on the basic number employed from the beginning) and he will become the recipient of the consideration paid upon entry into the plan by all new recruits.

The uncertainty of performance by subsequent participants over whom prior participants have no control has provided the element of chance necessary to characterize endless chain schemes as lotteries; and it is submitted that the same contingencies exist in the referral selling plans with which we are here concerned. In *Public Clearing House v. Coyne* (1904) 194 US 497, 515, 24 S.Ct. 789, 48 L.Ed. 1092, 1101, the Court said of a plan which, true to "endless chain" fashion, rewarded its members in direct proportion to the number of new members who entered the plan:

"It is true, as urged by the counsel for complainant, that in investing money in any enterprise the investor takes the chance of small profits, or even of failure, as well as the hope of large profits; but such enterprises contemplate the personal exertions of the investor, or of his partners, agents, or employees, while in the present case his profits depend principally upon the exertions of others, over whom he has no control, and with whom he has no connection. It is in this sense the amount realized is determinable by chance."

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Furthermore, this office held in an opinion issued to Hon. Franklin T. Thackery under date of December 17, 1957, that an "endless chain" scheme involving United States savings bonds was a lottery because the possibility of a given participant's name rising to the top of the list (which theoretically would result in his receiving \$19,200.00 worth of bonds as a return for his initial investment of \$37.50 to get into the plan) depended solely on the diligence of those who would later join the plan to sell new memberships. On page 6 of that opinion, the following appears:

"In your factual situation, the participant, by his own efforts, may be successful in reducing his financial investment in the scheme to nothing, depending upon his own ability as a salesman. Yet, the amount which he will receive in return for his efforts, indeed whether he will receive anything, depends upon the success and willingness of those who come after him in keeping the chain unbroken until his name reaches the top of the list. Since these are people over whom he has no control, this constitutes chance according to all the authorities we have been able to find."

We therefore believe that the element of chance is present in the instant case and that the referral selling schemes discussed above are lotteries as prohibited by our constitution and as condemned by Sections 563.430 and 563.440, RSMo 1959.

#### CONCLUSION

On the basis of the foregoing authorities, it is the opinion of this office that a referral selling scheme whereby the reward to the initial buyer depends upon the success of the efforts of the promoter of the plan to sell

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to persons to whom he is referred by the initial buyer or subsequent participants constitutes a lottery under Missouri law.

The foregoing opinion, which I hereby approve, was prepared by my assistant, Albert J. Stephan, Jr.

Very truly yours

  
THOMAS F. EAGLETON  
Attorney General