Multilevel Marketing: A Historical Perspective

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Throughout the twentieth century retailing in the United States experienced significant and enduring changes: the growth of chain stores, the adoption of self-service, the development of franchising, and the growth of e-commerce, to name a few. The direct selling area of retailing—with its origins dating to peddlers, door-to-door sales representatives, and party plans—similarly experienced significant change. By mid-century multilevel marketing developed as a specific form of direct selling. In 2011 over ninety-five percent of member firms in the Direct Selling Association (DSA) reported having a multilevel marketing structure [i]. In short, direct selling in the United States essentially equates to multilevel marketing. This paper documents the historical foundations that led to this transformation and the marketing and legal issues that developed subsequent to that growth.

Historical Foundations: A multilevel sales approach

Readily available sources attribute the origin of multilevel marketing as a form of direct selling in the United States to either Dr. Carl Rehnborg, the founder of the California Vitamin Company (later named Nutrilite) or the two men responsible for the national distribution of his products, Lee S. Mytinger and William S. Casselberry. According to these sources, Mytinger and Casselberry, in consultation with or under the direction of Dr. Rehnborg, devised an approach whereby distributors purchased products at a thirty-five percent discount and then played the dual role of retailing products to non-distributor consumers while also recruiting new distributors in a pyramid-type structure. The original distributor would become eligible for bonuses and commissions based on the number of customers and distributors “working below him” [ii, iii].

Mytinger and Casselberry experienced both considerable success and legal problems. From 1945 to 1947, Nutrilite national sales increased to $500,000 per month. In 1948 the Food and Drug Administration (FDA) began investigating the firm for making exaggerated product claims. Similar to patent medicine salesmen in the nineteenth century, sales representatives’ claims regarding product efficacy became an issue. The multilevel marketing structure, however, had proven successful. Another legal issue developed when a lawsuit against former distributors, who had moved the structure to a competing firm, prompted a Federal Trade Commission (FTC) investigation into the Nutrilite distributor contract. Two Nutrilite distributors, Richard DeVos and Jay Van Andel adopted a similar multilevel marketing structure for selling noncompeting cleaning products and, during a period of turbulence at Nutrilite, created the separate Amway Corporation. Amway, which now owns Nutrilite, would become the prototype multilevel marketing firm and the twenty-eighth largest private company in the United States [iv].

Direct selling in its various forms (e.g., peddlers, consignment agents, etc.) existed in the United States since Colonial days. Thus, it is not surprising to find earlier references to a multilevel structure in direct selling. Early African-American beauty products companies, including one owned by Madam C. J. Walker, the first woman and first African-American millionaire in the United States, adopted a “pyramid” structure.

Another common business practice among women in the early twentieth century beauty trade was the direct sales methods known today as multilevel marketing or “pyramid” organization. Operator-agents not only sold beauty services and products, but recruited women into their organizations and trained them in their systems. Among the most successful to capitalize upon multilevel marketing were black women selling hair care systems, many of whom gained local and even national markets among African Americans. Annie Turnbo Malone and Madam C. J. Walker achieved unusual success in manufacturing and marketing hair-care
products for black women, but they also exemplify trends much more widespread (Peiss, 1998).

The Madame C. J. Walker Manufacturing Company provided employment for over three thousand people and Walker herself claimed that her multilevel sales force had over 20,000 agents by 1919 [vi].

The structure of these earlier multilevel direct selling systems are lost, and the distributor levels and compensation structures unknown. Clearly, however, some early entrepreneurs did adopt a sales force system of distributors recruiting new distributors.

**The Pyramid Scheme Question**

The popular press, regulatory activity, and academic research have linked some multilevel marketing structures to the less positive traditions of scams, chain letters, and pyramid schemes. “It has been estimated that several hundred million dollars a year are lost by investors in these operations, mostly questionable multi-level distributorship deals and pyramid schemes” (Changing Times, 1971). In its simplest form a pyramid scheme is a crude wealth transfer scheme akin to a chain letter. The original recruit moves up a compensation pyramid as they bring in new recruits that, in turn, bring in recruits until the original recruit reaches the top of the pyramid and maximum compensation. The scheme often relies on social and/or religious ties. Variations of this approach included themes such as “people helping people” and “women helping women” [vi, vii]. Since the 1990s a number of multilevel marketing firms selling products and services have been found to be operating pyramid schemes.

The prosecution of Glenn W. Turner offers a specific early example of a pyramid structure in marketing his “Dare to Be Great” motivational seminars and his Koscot Interplanetary multilevel marketing of cosmetics (Lichtenstein, 1972). Both efforts prompted regulatory action by the FTC, and the Koscot case produced the first “test” criteria for identifying a pyramid scheme operating with a multilevel marketing structure. Subsequent court decisions have led researchers to explore a range of ethical and legal questions regarding multilevel marketing (Koehn, 2001).

**The Argument for a Multilevel Marketing Structure**

By design, direct selling firms rely more on the selling skills of their sales forces than on indirect communications such as advertising. Proponents of direct selling point to low fixed costs compared with operating retail stores, valued social relationships among customers and between sales representatives and customers, and the persuasiveness of personal selling (Frenzen and Davis, 1990; Greco, 1996). The multilevel marketing approach limits some negative aspects of traditional direct selling while enhancing the role of entrepreneurship. By rewarding current distributors in hierarchical fashion for sales made by their direct and indirect recruits, the parent company shifts the burden of recruiting and training new people onto the existing sales force (Sherman, 1991). These tasks are accomplished with support from the parent firm. Distributors are rewarded for personal sales and motivated by the entrepreneurial aspect of being an independent contractor who builds a “downline” of distributors. The multilevel marketing structure provides the additional benefit of shifting some operating expenses from fixed to variable costs (Vander Nat and Keep, 2002). These benefits are reinforced by the sale of proprietary products and brands not available through another distribution or sales channel.

Companies have used variations of the multilevel marketing structure to sell health and beauty products, household consumables, services such as travel, and even energy. Numerous multilevel marketing firms report annual sales in billions of dollars with distribution networks operating in multiple countries. Some are publicly traded. As with companies in other industries, many multilevel marketing firms support political candidates inclined to maintain a business environment favorable to the business model.

Despite these successes, the FTC and Securities Exchange Commission (SEC) continue to raise questions. After Amway prevailed in the 1979 seminal FTC v. Amway case, regulatory activity declined sharply. An increase in the number and variety of multilevel marketing firms in the 1990s brought renewed interest. Between 1996 and 2002, the FTC charged more multilevel marketing firms with operating a pyramid scheme than in the previous seventeen years. During that period the SEC also successfully prosecuted International Heritage Inc., the largest pyramid scheme case brought against a publicly traded company (Vander Nat and Keep, 2002; SEC News Digest, 2000). Recently
the FTC successfully sought more clarity in the FTC v. BurnLounge case, now in appeal (Federal Trade Commission, 2012).

Research Purpose

More than half a century after the initial success of Nutrilite, companies operating with a multilevel marketing structure continue to grow and continue to face legal questions. Prosecutors have brought successful pyramid scheme charges against multilevel marketing firms with products ranging from digitally downloaded music, to travel, to nutrition and wellness. Federal and state prosecutors have forced changes in company marketing messages and documentation. In some cases, company officers have been sentenced to prison. In December 2012, the CEO of a hedge fund accused Herbalife, a thirty-two-year-old public multilevel marketing firm reporting over $3.5B in worldwide sales, of operating a pyramid scheme (Alden, 2012). Herbalife is one of a small number of large, publicly traded multilevel marketing companies. The apparent contradiction between the global growth of multilevel marketing, its virtual dominance as a business model among members of the DSA, and persistent questions about illegal pyramid schemes offer a unique research topic.

Source Material

The research will rely upon sources ranging from company statements, articles in the popular press, court cases, and academic research.

Notes


Sample References


Changing Times (1971), “Nobody ever got rich on chain letters: Yet some folks sink their savings into the same idea when it’s dressed up as a “business opportunity”, Vol. 5 No. 9 (September), p. 31.


