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Iowa Consumer Fraud Act Prohibits Earning Money by Referrals Rather Than by Product Sales

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False Advertising

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feasible absent the class action. Thus, the class action would allow the individuals to have their day in court.

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Iowa Consumer Fraud Act Prohibits Earning Money By Referrals Rather Than By Product Sales

In ***State of Iowa v. Santa Rosa Sales and Marketing, Inc.***, 475 N.W.2d 210 (Iowa 1991), the Iowa Supreme Court held that the Iowa Consumer Fraud Act prohibited a company from earning money by engaging in referral sales, which motivate buyers to become salespersons and recruit others, rather than by generating the sales of products. The court also held that the company deceived its brokers and salespersons by misrepresenting the legality of its silver coin sales program.

Background

Santa Rosa Sales and Marketing, Inc. ("Santa Rosa") is a California corporation engaged nationwide in selling contracts for Silver Eagle coins. The coins are United States currency with a face value of one dollar that Santa Rosa offered at three for $80 or twenty for $500. The coins are also sold nationally in coin shops, banks, and over cable television for prices ranging from $6 to $65 per coin. Charles R. Groeschel ("Groeschel") was Santa Rosa's founder, chairman of the board, former president, and person responsible for marketing procedures. Groeschel and his wife were the sole shareholders of Santa Rosa.

Santa Rosa's sales were made by brokers or salespersons who sold contracts; purchasers of contracts could become brokers or salespersons themselves. Brokers were distinguished from salespersons in that brokers received training and ongoing continuing education from Santa Rosa, but salespersons did not. Brokers were contractual employees who were required to comply with Santa Rosa's written policies. After a broker completed a presentation, prospective clients were given the opportunity to buy coins or sign up to be salespersons.

First-time purchasers bought one or more starter contracts at a cost of either $80 or $500. The purchase agreement for those choosing to become salespeople contained a provision requiring twelve completed sales of coin contracts before they would be paid. Salespersons who did not sell twelve completed coin contracts within thirty days were removed from the referral program, and the initial $80 or $500 payment became a direct purchase of the coins. Purchasers of coin contracts were given the option to never take possession of the coins. In theory, Santa Rosa bought back the coins that purchasers never received, resold them, and then sent the purchasers cash. Eighty-five percent of Iowans who purchased contracts opted not to take possession of the coins.

ANNOUNCEMENT

Top Consumer Scams of 1991

The Alliance Against Fraud in Telemarketing has published a list of the top ten consumer scams in 1991 in the United States. In order, they are:

1. Postcard Guaranteed Prize Offers
2. Advance Fee Loans
3. Fraudulent 900 Number Promotions
4. Precious Metal Investment Schemes
5. Toll Call Fraud (Con artists use binoculars to read calling card numbers of travelers placing long-distance phone calls from airports and train stations.)
6. Headline Grabbers (For example, thousands of people agreed to let military personnel use their long distance calling card numbers to call back to the United States.)
7. Direct Debit from Checking Accounts
8. Phony Yellow Page Invoices
9. Phony Credit Card Promotions
10. Collectors' Items

See ***Alliance Against Fraud in Telemarketing***, Fall, pp. 1-2 (1991).

Trial Court

The State of Iowa sued Santa Rosa alleging that the company violated Iowa's Consumer Fraud Statute, Iowa Code 714.16 (1987), by committing unlawful practices of: (1) referral sales; (2) misrepresentations; (3) violations of the Door-to-Door Sales Act, Iowa Code ch. 82; and (4) violations of the lottery statute, Iowa Code 725.12 (1987).

The District Court, Polk County, Iowa enjoined Santa Rosa's marketing program and held the company liable for a restitution fund of $196,463 to be administered by the State. The court ordered Iowa to make restitution to Santa Rosa consumers from the fund and deposit any remainder with the Iowa Consumer Education and Litigation Fund. Additionally, the court assessed a civil penalty and prejudgment interest and held Groeschel personally liable. Santa Rosa appealed to the Iowa Supreme Court.

Statute Prohibits Referral Sales

Although the statutory language of the Iowa Consumer Fraud Statute does not contain the word referral, the Iowa Supreme Court has interpreted 714.16(2)(b) as prohibiting referral sales. Generally in a referral sales program, the seller represents that the buyer's purchase price will be reduced or that the buyer will receive a commission by referring other prospects to the seller. Santa Rosa argued that its program was not an illegal referral sales plan because a salesperson's compensation was determined by the sale of coins and not by the recruitment of other salespersons.

However, consumer testimony, broker training materials, sales documents, and actual broker presentations, combined with data showing that only a fraction of Iowa purchasers opted to take Silver Eagle coins, established that Iowa purchasers were not motivated by the desire to own Santa Rosa's Silver Eagle coins, but rather, to make easy money by recruiting others. Therefore, the supreme court affirmed the trial court's conclusion that Santa Rosa's money-

making objective was the type of referral sales program the Iowa legislature wanted to prohibit.

Santa Rosa's Misrepresentations

The court then turned to the issue of misrepresentation of potential earnings and the program's legality. Santa Rosa admitted that certain brokers misrepresented the dollar amounts purchasers could earn. However, Santa Rosa argued that it was not responsible, because "renegade brokers" made the misrepresentations. The supreme court disagreed for two reasons. First, broker training materials contained assurances of quick and easy money. Second, Santa Rosa failed to develop a system to monitor either the new brokers or their training. Therefore, the supreme court held that Santa Rosa could not disclaim responsibility for the misrepresentations of its brokers.

Santa Rosa also admitted that its brokers misrepresented the program's legality, but again denied responsibility for renegade brokers. The supreme court rejected Santa Rosa's claim as meritless and found the misrepresentations traceable directly to Santa Rosa's broker training materials. For example, in a document entitled "Questions Most Frequently Asked About The Santa Rosa Plan," the first question on the document was "1. Q. Is this plan legal? A. Yes!" However, Santa Rosa made no attempt to determine whether its program was in compliance with Iowa law until four months after Santa Rosa sales began. As a result of these misrepresentations, the Iowa Supreme Court found Santa Rosa liable for violating the state's Consumer Fraud Act.

Remaining Issues

The supreme court partially reversed the trial court and held that violations of the Door-to-Door Sales Act and lottery statute were not unfair practices as defined by the Iowa consumer fraud statute. The court reasoned that the legislature's failure to include violations of the Act or lottery statute as unfair practices revealed an intent to exclude them.

Next, Santa Rosa argued that since the restitution fund was designed solely to reimburse Iowa residents who made purchases from Santa Rosa, the trial court erred when it awarded the unclaimed balance to the Iowa Consumer Education and Litigation Fund. The supreme court agreed and directed the trial court on remand to return any undistributed portion of the restitution fund to Santa Rosa.

The court then turned to the imposition of the civil penalty. Santa Rosa contended that no penalty should have been awarded because renegade brokers violated the law without Santa Rosa's consent or encouragement. The supreme court concluded that Santa Rosa impliedly authorized and encouraged the ideas and sales techniques used by the brokers and therefore, the civil penalty was appropriate.

Next, the court examined the personal liability of Santa Rosa's owner, Groeschel. The supreme court upheld the trial court finding that Groeschel's liability arose as a consequence of his complete control of Santa Rosa and his own personal acts in perpetrating consumer fraud.

Lastly, the supreme court held that the award of prejudgment interest was improper because the state legislature intended to exclude prejudgment interest from the definition of restitution in the consumer fraud statute.

Judy Koehler

Negligent Termite Inspector Can Be Liable To Forseeable Subsequent Home Purchasers

In ***Hosford v. State Termite and Pest Control, Inc.***, 589 So. 2d 108 (Miss. 1991), the Supreme Court of Mississippi held that a pest control operator, who negligently inspected residential property in the process of being sold, may be liable to forseeable subsequent purchasers of the house.

Background

In 1986, Jim and Judy Hosford ("the Hosfords") hired McCrary Real Estate, Inc. in an effort to buy a home in Columbus, Mississippi. On July 11, 1986, the Hosfords, through the services of McCrary Real Estate, agreed to purchase a house and received the corresponding warranty deed. For procedural purposes, title first was transferred to Johnny Mack McCrary ("McCrary"), principal in McCrary Real Estate, who then transferred the property to the Hosfords.

Before the closing, McCrary contacted State Termite and Pest Control, Inc. ("State Termite") and requested an inspection of the property for possible termite damage. Steve McKissack ("the Inspector"), a pest control specialist employed by State Termite, performed an inspection of the premises and prepared a report stating the results. The report listed Charles Smith as the current owner of the property and McCrary, individually, as the purchaser. The report was one of the documents submitted at the closing of the property purchase in July, 1986.

The Inspector's report stated that there was no infestation or damage from wood-destroying insects on the property. The inspection covered the readily accessible areas of the property, but did not include areas that were obstructed or inaccessible at the time of inspection. The report also stated that it was not a structural damage report nor a warranty as to the absence of wood-destroying insects.

In January, 1988, nineteen months after the inspection, Jim Hosford noticed conditions suggesting termite infestation and damage. He had the property inspected by a carpenter and, later, by two employees of the Pest Control Section of the United States Department of Agriculture. These parties reported substantial termite infestation and damage that had existed for more than two years and possibly as long as fifteen years. The parties also agreed that the damage should have been discovered if the recent, June, 1986 inspection by State Termite had been performed competently.

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