BYU Law Review

Volume 1976 | Issue 1 Article 6

3-1-1976

Constitutional Law - Impairment of Contracts - Pyramid Sales Schemes - Remaining Limitations, If Any, on the Police Power Under the Contract Clause - Koscot Interplanetary, Inc. v. Draney

Constitutional Law—IMPAIRMENT OF CONTRACTS—PYRAMID SALES SCHEMES—REMAINING LIMITATIONS, IF ANY, ON THE POLICE POWER UNDER THE CONTRACT CLAUSE—*Koscot Interplanetary, Inc. v. Draney*, 530 P.2d 108 (Nev. 1974).

Koscot Interplanetary, Inc. (Koscot) sold cosmetics in Nevada through the use of a "pyramid promotional scheme." In 1971, Nevada enacted a statute, hereinafter referred to as chapter 598, which prohibited all future pyramid schemes and made contracts entered into prior to the effective date of the statute voidable if the right to participate in a pyramid promotional scheme formed any part of the consideration.[1] Before chapter 598 became effective, plaintiffs contracted with Koscot for the right to participate in a pyramid plan and paid Koscot the contract price. After the effective date of the Act, plaintiffs requested Koscot to refund their investment and, upon refusal, sued for rescission.

The District Court for the Second Judicial District of Nevada found that the contract was voidable under chapter 598 and granted summary judgment to the plaintiffs. Koscot appealed, claiming that the portion of chapter 598 making contracts entered into before the enactment of the statute voidable violated the contract clauses of the United States[2] and Nevada Constitutions.[3] The Nevada Supreme Court held that the statute was a legitimate use of the police power and was therefore valid even though contractual obligations were affected.

I. BACKGROUND

A. *Pyramid Sales Plans and the Legal Efforts to Control Them*

Pyramid sales organizations have been a source of controversy since the mid-1960's.[4] In a typical pyramid situation, a participant pays a substantial sum to obtain a company position and attempts to recover his investment through commissions

1. NEV. REV. STAT. §§ 598.100-.130 (1973).

2. U.S. CONST. art. 1, § 10, provides: "No State shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts . . . ."

3. NEV. CONST. art. 1, § 15, provides: " No . . . law impairing the obligation of contracts shall ever be passed. . . ."

4. *See* Comment, *Multi-Level or Pyramid Sales Systems: Fraud or Free Enterprise*, 18 S. DAK. L. REV. 358 (1973) [hereinafter cited as *Multi-Level*].

For additional information on pyramid schemes and comment on various suggested solutions to the pyramid contract problem see Comment, *Federal Regulation of Pyramid Sales Schemes*, 1974 U. ILL. L.F. 137; Comment, *Toward a Uniform Approach to Multilevel Distributorships*, 8 U. MICH. J.L. REF. 546 (1975); and Note, *Regulation of Pyramid Sales Ventures*, 15 WM. & MARY L. REV. 117 (1973).

from product sales and from additional commissions received by enlisting others in the organization. This right to receive substantial commissions by persuading others to buy a company position distinguishes pyramid schemes from traditional marketing methods and is often the most financially rewarding right gained from pyramid contracts.[5]

The major source of fraud found in pyramid schemes is that returns on investment usually come from position-selling rather than from product sales. Often the market for the product cannot support the huge sales organization which develops, and those participating in the plan can make money only by enticing others to join. When new recruits are found, they then face the same problem previously faced by those who persuaded them to join: they cannot effectively sell the product and must therefore try to enlist others to recover their investment.[6] This fundamental weakness of endless-chain schemes is amplified by the tendency to misrepresent earnings in terms of what is remotely possible instead of informing prospects of what is actually earned in real-life situations.[7]

Because pyramid plans have frequently been used as a vehicle for fraud, legislative and judicial reaction to these schemes has been swift. Many states have prohibited pyramid promotional schemes by name or through expanded consumer fraud statutes.[8] A few states allow such schemes but strictly regulate them.[9] In the absence of legislation specifically aimed at pyramid contracts, courts have invalidated many such contracts on the grounds of fraud,[10] restraint of trade,[11] security registration viola-

5. *See Multi-Level, supra* note 4, at 359-67.

6. Even if the product is marketable, recruits find it easier to find new recruits than to sell. Because of the principles of geometric progression and the incentive to get others to join, the market is easily saturated with an over-abundance of sellers. As a matter of mathematical certainty, the plan will fail somewhere along the line unless participants expect income to come basically from product-selling. *Id.* at 365-67.

7. One commentator stated: "Because the 'plan' often looks better on paper than it works in practice, it lends itself to being manipulated by clever and sophisticated people . . . ." *Id.* at 361.

8. *Id.* at 380 & n.133.

9. *See, e.g.*, MD. ANN. CODE art. 83, § 166 (Supp. 1974); MASS. GEN. LAWS ch. 93, § 69 (1973); S.D. COMPILED LAWS ANN. § 37-25-01 to -28 (1975).

10. *See, e.g.*, State *ex rel.* Turner v. Koscot Interplanetary, Inc., 191 N.W.2d 624 (Iowa 1972); Kugler v. Koscot Interplanetary, Inc., 120 N.J. Super. 216, 293 A.2d 682 (Super. Ct. 1972); Commonwealth *ex rel.* Speaker v. Koscot Interplanetary, Inc., Equity Docket No. 57 (C.P. Erie County Pa. 1970).

11. *See* Kugler v. Koscot Interplanetary, Inc., 120 N.J. Super. 216, 293 A.2d 682 (Super. Ct. 1972). *Multi-Level, supra* note 4, at 372-74.

tions,[12] unconscionability,[13] and as illegal lotteries.[14]

The Nevada statute contested in the present case, chapter 598, differs from other legislation in this area in that it makes pre-legislation pyramid contracts voidable in addition to prohibiting future pyramid schemes. Legislation prohibiting future pyramid promotional schemes has been upheld.[15] Prior to the present case, however, no statute making voidable pyramid-scheme contracts entered into and paid for before its passage had yet been challenged.

B. The Contract Clause

1. Legislative history

From the scant legislative history available, it appears that the contract clause of the federal Constitution was originally intended to have an effect in civil actions similar to that which the *ex post facto* provision has in criminal matters.[16] On August 22, 1787, the Constitutional Convention adopted a provision forbidding Congress, the national legislature, from enacting any *ex post facto* law.[17] Six days later, on August 28th, Rufus King moved to add a provision prohibiting the states from interfering "in private contracts."[18] Many delegates opposed the proposal, fearing that such a far-reaching clause would excessively hinder state legislatures. Proponents assured the critics that King's provision prohibited only retrospective interferences.[19] Nevertheless, the dele-

12. *See, e.g.*, Hurst v. Dare to be Great, Inc., 474 F.2d 483 (9th Cir. 1973); Frye v. Taylor, 263 S.W.2d 835 (Fla. App. 1972); State v. Hawaii Market Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971); State *ex rel.* Healy v. Consumer Business System, Inc., 5 Ore. App. 284, 482 P.2d 549 (1971); State *ex rel.* Park and McEldowney v. Glen Turner Enterprises, Inc., 3 BLUE SKY L. REP. ¶ 71,023 (4th Dist. Ct. Idaho 1972).

Not all courts, however, have defined "investment contract" to include pyramid contracts and have held the security requirements to be inapplicable. *See, e.g.*, Koscot Interplanetary, Inc., v. King, 452 S.W.2d 531 (Tex. Civ. App. 1970). *See generally Multi-Level, supra* note 4, at 375-78; Annot., 47 A.L.R.3rd 1366 (1973).

13. *See* State *ex rel.* Lefkowitz v. ITM, Inc., 52 Misc. 2d 39, 275 N.Y.S.2d 303 (1966).

14. *See, e.g.*, Frye v. Taylor, 263 So. 2d 835 (Fla. App. 1972); People *ex rel.* Kelley v. Koscot Interplanetary, Inc., 37 Mich. App. 447, 195 N.W.2d 43 (1972); *Multi-Level, supra* note 4, at 370-72.

15. *See* State *ex rel.* Sanborn v. Koscot Interplanetary, Inc., 212 Kan. 668, 512 P.2d 416 (1973).

16. *See* B. WRIGHT, THE CONTRACT CLAUSE OF THE CONSTITUTION 4-26 (1938) [hereinafter cited as WRIGHT].

17. Crosskey, *The Ex-Post Facto and Contracts Clauses in the Federal Convention: A Note on the Editorial Ingenuity of James Madison*, 35 U. CHI. L. REV. 248, 248-49 (1968) [hereinafter cited as Crosskey].

18. *Id.* at 248.

19. WRIGHT, *supra* note 16, at 9; Crosskey, *supra* note 17, at 248-49.

gates did not adopt King's motion at that time. Rather, they adopted a substitute motion by John Rutledge prohibiting the states from enacting *ex post facto* laws or, as recorded in Madison's notes, "retrospective laws."[20] The following day, August 29th, John Dickinson, according to some sources, advised the Convention that the term *ex post facto* was used at common law only in criminal actions.[21] The Convention responded with the contract clause; its purpose, under the most widely accepted view, was to insure that *ex post facto* concepts would be extended to civil matters.[22] Significantly, this civil-criminal distinction was adopted in the 1798 case of *Calder v. Bull*[23] where the United States Supreme Court, at least partially influenced by the assumption that the contract clause performed an equivalent function in the civil area,[24] limited the *ex post facto* clause to criminal matters.

While the economic uncertainty and debtor relief measures prevalent prior to the Constitutional Convention have encouraged speculation that the contract clause was inserted to promote economic stability, the records of the Convention provide little direct support for this position. The faint light shed by those

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20. WRIGHT, *supra* note 16, at 9 & n.16.

21. *Id.* at 10 & n.21.

Professor Crosskey, however, asserts that the incident involving John Dickinson probably never occurred and that James Madison invented the episode in order to promote his personal beliefs concerning the role that the contract clause should play. Crosskey further argues that Madison consciously omitted key details and deliberately altered his records of the Convention in an effort to create the illusion that the contract clause was an extention of the *ex post facto* clause. *See* Crosskey, *supra* note 17, at 248-54.

22. *See* WRIGHT, *supra* note 16, at 4-16.

If Professor Crosskey's position that Madison made misleading statements is accepted, however, the idea that the contract clause was originally intended to apply *ex post facto* protections in limited civil areas is not as obvious (*See* note 21 *supra*). Nevertheless, the fact that proponents of the contract clause specifically told their critics that the clause would only prohibit retrospective interferences has not been challenged, and the response of those critics demonstrates that Madison's belief that the contract clause prohibited retrospective legislation was shared by others. *See* note 19 and accompanying text *supra*. Furthermore, given the confusion that existed concerning the scope of the *ex post facto* clause, Rutledge's substitute motion may have been intended to prohibit both civil and criminal *ex post facto* measures. *See* note 20 and accompanying text *supra*.

23. 3 U.S. (3 Dall.) 386 (1798).

24. The Court said:

> The restriction not to pass any *ex post facto law* was to secure the *person* of the subject from injury, or *punishment* in consequence of *such law*. If the prohibition against making *ex post facto laws* was intended to secure *personal rights* from being affected, or injured, by such laws, . . . the *other* restraints [embodied in the contract clause] I have not enumerated, were unnecessary, and therefore improper, for both of them are *retrospective*.

Id. at 390 (emphasis in original).

records reveals only its relationship to the *ex post facto* clause[25] described above. Consequently, the development of the contract clause into "a mighty instrument for the protection of the rights of private property"[26] was the result of judicial activism.[27]

2. The contract clause and judicial activism

The initial Supreme Court decisions concerning the contract clause extended the protections of the clause to grants,[28] contracts,[29] and charters[30] to which the state is a party, and demonstrated the judiciary's determination to preserve the sanctity of contracts. For example, in *Fletcher v. Peck*,[31] the Court declared unconstitutional an act that revoked an earlier grant of land even though the initial grant was obtained through fraud and bribery. In *New Jersey v. Wilson*,[32] the state was told that it could not revoke a contractually-incurred grant of perpetual tax immunity. This insistence that legislatures could not alter significant terms of contracts was most forceably declared in *Sturges v. Crowinshield*,[33] where Chief Justice Marshall declared that "the Convention appears to have intended to establish a great principle that contracts should be invoidable,"[34] and held that state bankruptcy laws could not affect contractual debts incurred before passage of the bankruptcy laws.

3. Limitations on the scope of the contract clause

Although these early cases conveyed the impression that contracts were virtually immune from legislative interference, limits

25. WRIGHT, *supra* note 16, at 8-18.
26. *Id.* at 28.
27. *Id.* at 27-61.
28. Fletcher v. Peck, 10 U.S. (6 Cranch) 87 (1810).
29. New Jersey v. Wilson, 11 U.S. (7 Cranch) 164 (1812).
30. Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).
31. 10 U.S. (6 Cranch) 87 (1810).
32. 11 U.S. (7 Cranch) 164 (1812).
33. 17 U.S. (4 Wheat.) 122 (1819).
34. *Id.* at 206.
Marshall also described the purpose of the clause in the following forceful terms:

> So much mischief was done, and so much more was apprehended, that general distrust prevailed, and all confidence between man and man was destroyed . . . .
>
> To restore public confidence completely, it was necessary not only to prohibit the use of particular means by which it [economic mischief] might be effected, but to prohibit the use of any means by which the same mischief might be produced.

Id. at 204, 206.

to the power and scope of the contract clause gradually appeared. Initially, the Court distinguished between the "remedy" and "obligation" parts of the contract stating that reasonable alterations of available remedies were permissible if the "obligation is not substantially impaired."[35] The impact of *Sturges* was further cushioned by the decision in *Ogden v. Saunders*,[36] which established the principle that the contract clause poses no barrier to laws which only affect contracts concluded after the legislature has acted. Later, in *West River Bridge Co. v. Dix*,[37] the Court stated that the state's power of "eminent domain" is an "inalienable state right" which can be exercised even though such exercise might affect contractual rights. Nevertheless, throughout most of the nineteenth century the courts, despite these early limitations, continued widespread use of the contract clause to invalidate state legislation.[38]

As the "police power" concept gained in prominence, however, the clout of the contract clause began to diminish. Because the states have an affirmative duty to promote the "health, safety, morals, and general welfare" of their citizens, it became apparent that the existence of a few contracts could not and should not prevent the state from enacting laws necessary to prevent future harm to its citizens.[39] Initially, this "police power rationale" was used to uphold laws that prevented parties from fulfilling contractual obligations made illegal by subsequent legislation. For example, in *Beer Co. v. Massachusetts*,[40] the High Court upheld a state prohibition law intervening between creation and execution of contracts for the sale of beer. Similarly, in *Stone v. Mississippi*,[41] legislation prohibiting lotteries was upheld even though previously-issued lottery tickets could not now be used.

Modern decisions have relied upon the police power rationale to permit legislatures to further manipulate specific contractual

35. This distinction mentioned in *Sturges v. Crowninshield* (*id.* at 207) was elaborated in *Bronson v. Kinzie*, 42 U.S. (1 How.) 311 (1843), where the Court held that certain changes in the state's mortgage-foreclosure laws so changed the "remedy" that the entire "obligation" was impaired.

36. 25 U.S. (12 Wheat.) 213 (1819).

37. 47 U.S. (6 How.) 507 (1848).

38. During the 19th century, the contract clause was used more than any other constitutional provision to invalidate state legislation. WRIGHT, *supra* note 16, at xii.

39. *See* WRIGHT, *supra* note 16, at 193-213; Hale, *The Supreme Court and the Contract Clause: II*, 57 HARV. L. REV. 621, 654-63 (1944); Comment, *The Continuing Vitality of the Contract Clause of the Federal Constitution*, 40 S. CAL. L. REV. 576, 586-89 (1967).

40. 97 U.S. 25 (1877).

41. 101 U.S. 814 (1879).

terms. Foremost among these cases is *Home Building and Loan Association v. Blaisdell*.[42] In that case, the Court upheld a law passed during the depression which prohibited mortgage foreclosures over a two-year period so long as the mortgagor paid rent, taxes, interest, and insurance during the extension period.[43] Although the case could conceivably have been decided on the traditional view that reasonable modifications of available remedies are permissible or on the basis that the state was exercising its "emergency powers,"[44] the decision rested upon the assertion that states can alter specific contractual provisions under the aegis of the police power.[45] Nevertheless, while asserting broad state power to modify contracts, the opinion is also riddled with descriptions of the economic emergency facing the nation, illustrations of ways in which substitute provisions provided by the contested act adequately compensated and protected the mortgagee, and statements explaining that the police power could not be allowed to destroy the limitation against impairment of contracts.[46] As a result, one is left with the clear impression that this power to alter contractual terms is limited.[47]

One limitation on the use of police power to modify or impair contracts is the requirement that legislation must actually promote the public welfare. In *Treigle v. Acme Homestead Association*,[48] the United States Supreme Court found that the contested statute did not actually promote the public good but only changed the relative positions of the contracting parties vis-a-vis each other. The Court struck down the statute involved, holding that a contract-impairing statute must promote the public welfare and not simply the private welfare of one of the con-

42. 290 U.S. 398 (1934).

43. *Id.*

44. *See*, WRIGHT, *supra* note 16, at 109-11; Comment, *The Continuing Vitality of the Contract Clause of the Federal Constitution*, 40 S. CAL. L. REV. 576, 586-89 (1967).

45. 290 U.S. at 444.

46. 290 U.S. 398, 415-48.

The balance which needs to be struck is best illustrated in these words:

> The reserved power [police power] cannot be construed so as to destroy the limitation [against impairment of contracts], nor is the limitation to be construed to destroy the reserved power in its essential aspects.

Id. at 439.

47. Although Wright's conclusion that *Blaisdell* merely decided the "very narrow question of the validity of the particular statute under the specific circumstances then existing" is over simplistic, the *Blaisdell* opinion does indicate that there are definite limits placed upon the police power's ability to impair contractual obligations. *See* WRIGHT, *supra* note 16, at 119.

48. 297 U.S. 189 (1936).

tracting individuals.[49] The Court then added that even if a contract-impairing law does promote the public good, the law must be "reasonable" and "reasonably adapted" to achieve the desired results before it can be found to be valid.[50]

Several post-*Blaisdell* cases indicate that statutory schemes which modify contractual obligations to a greater extent than necessary to achieve the legislative ends are "unreasonable" and therefore unconstitutional.[51] In *Louisville Joint Stock Land Bank v. Radford*,[52] the Supreme Court refused to validate a mortgage-foreclosure moratorium similar to that upheld in *Blaisdell* simply because the provisions in the *Blaisdell* statute requiring payment of reasonable rent and taxes during the extension period were absent.[53] In *W.B. Worthen Co. v. Thomas*,[54] legislation passed during the Depression which exempted insurance policy benefit payments from garnishment was invalidated because no time limits were placed upon the act and because no attempt was made to differentiate between debtors who could afford to pay and those who could not.[55] A similar result was reached in *Worthen Co. v. Kavanaugh*,[56] where procedures used to protect property owners and to enforce bond payments were so substantially changed that the Court struck down the legislation as oppressive and unnecessary.[57]

The most recent Supreme Court decision on the contract clause, *City of El Paso v. Simmons*,[58] held that a law which substituted a five-year right of redemption for an original grant of an

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49. *Id.* at 195, 197.

50. *Id.* at 197.

51. It is incorrect to assume that the only requirement for the validity of contract-impairing legislation is that it be rationally related to a public end. An examination of *Blaisdell* and post-*Blaisdell* cases indicates that legislation with a rational basis will, when a contract clause attack is mounted, receive close judicial scrutiny. Many laws that impaired the obligation of contracts more than necessary to achieve the desired public result have been held unconstitutional. *Cf.* WRIGHT, *supra* note 16, at 111-19.

52. 295 U.S. 555 (1935).

53. In his majority opinion, Justice Brandeis asserted that no substantive right was impaired in *Blaisdell* because of the compensatory provisions which the statute in that case provided. Absent those provisions, the statute in *Radford* impaired substantive rights. *Id.* at 581.

54. 292 U.S. 426 (1934).

55. *Id.* at 434.

Distinguishing the *Blaisdell* case, Justice Hughes restated his opinion that the police power "must be construed in harmony with the fair intent of the constitutional limitation" and that the police action "must be limited by reasonable conditions appropriate . . . to the exigency to which the legislation was addressed." *Id.* at 433-34.

56. 295 U.S. 56 (1935).

57. *Id.* at 60-63.

58. 379 U.S. 497 (1965).

unlimited right of redemption on land sold by the State of Texas over fifty years earlier was, in light of the circumstances, a valid and reasonable exercise of the police power. In upholding this change, the Court stressed the insignificance of the modification and noted that the reinstatement provisions were nonessential terms that did not induce the original investors to enter into the contract.[59] The emphasis placed by the Court on the trivial nature of the modified terms has prompted suggestions that unless the legislation is of the type that makes contractually-obligated conduct illegal, major contractual terms cannot be modified if adequate substitute provisions are absent.[60] At the very least, the *El Paso* decision demonstrates that the public good to be accomplished must be weighed against the contractual rights lost in determining a statute's "reasonableness."[61]

II. INSTANT CASE

The Nevada Supreme Court relied heavily on the traditional "police power" analysis formulated in *Home Building and Loan Association v. Blaisdell*[62] to reach its conclusion that existing contracts could be invalidated by legislative action.[63] The court briefly reviewed the methods used by the defendant in Nevada and concluded that the defendant's contracts and policies were "nothing but a fraudulent scheme."[64] The abuses found in the defendant's operations demonstrated the need for legislative protection from such plans. After noting that the legislature has wide discretion in enacting laws and that such laws carry a presumption of validity,[65] the court summarized its response to the contract clause challenge in these words:

> Although contracts previously entered into may be affected thereby, the constitutional interdiction against the impairment of the obligation of contracts does not prevent a state in the reasonable exercise of its police power from enacting laws intended to benefit the public.[66]

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59. *Id.* at 514, 516-17.

60. *See* Kraft & St. John, *The Contract Clause as the Guardian Against Legislative Impairment of Municipal Bondholders' Rights*, 6 SETON HALL L. REV. 48, 59 (1974).

61. The tenor of the entire *El Paso* opinion suggests that the degree of public welfare, the importance of the term which is altered, and the availability of less onerous methods are all to be weighed to determine a statute's validity. *See generally* 379 U.S. at 517-35 (Black, J. dissenting).

62. 290 U.S. 398 (1934).

63. 530 P.2d at 112-14.

64. *Id.* at 112.

65. *Id.* at 113.

66. *Id.*

In response to the defendant's contention that the police power could only impair contracts in emergency situations not found in the present case, the court properly concluded that an emergency situation is not a prerequisite to the valid exercise of the police power. It then reiterated its belief that for a contract-impairing law to be valid it need only promote the public welfare, by stating that "where the police power is exercised 'for an end which is in fact public,' contracts must yield to the accomplishment of that end."[67] Finally, the court concluded that regulation of pyramid sales contracts was an "end which is in fact public" and that the entire statute was therefore valid.[68]

III. Analysis

A. The Court's Use of Prior Contract Clause Cases

The historical development of the contract clause and the holdings of several post-*Blaisdell* decisions demonstrate that the power to modify contractual obligations is not unlimited. In reaching its conclusion that making prelegislation contracts voidable was a legitimate use of the police power, however, the Nevada Supreme Court failed to wrestle with and apply limiting features of the contract clause that, given the facts of the instant case, ought to have been applied. This failure was due in part to the court's misplaced reliance on or misapplication of several prior contract clause cases. Before examining that particular difficulty with the court's decision, however, an undoubtedly correct aspect of the decision merits comment.

Certain provisions of chapter 598 prohibit future pyramid sales contracts.[69] Those provisions must, however, significantly affect existing contracts, given the fact that the right to earn commissions from position-selling is the most important right of pyramid contracts. Nevertheless, the state's right to protect its citizens from the harm which it reasonably believes will occur from a continuation of pyramid-selling practices cannot be thwarted simply because the exercise of that right will, in the future, affect already-existing contracts. Indeed, the future-oriented provisions of chapter 598 are, in substance, analogous to the statute upheld in *Beer Co. v. Massachusetts*[70] that prohibited

67. *Id.* at 114, quoting Treigle v. Acme Homestead Ass'n, 297 U.S. 189 (1936).
68. 530 P.2d at 114.
69. Nev. Rev. Stat. §§ 598.110-.130 (1973).
70. 97 U.S. 25 (1877).

future sales of alcohol. Given the continuing validity of the *Beer Co.* case, the court's determination in the instant case that the similar provisions of chapter 598 are constitutional is sound.

Other provisions of chapter 598 are aimed directly at already-existing contracts and at past actions, in that prelegislation contracts may be voided by the purchaser. It was in that part of its decision upholding these provisions that the court misapplied precedent. The cases used by the court to support its holding dealt solely with statutes affecting or regulating contractual obligations that had *not yet* been performed. In effect, the court extended the police power rationale of those cases to permit retroactive invalidation of completed contractual transactions. But the United States Supreme Court, in its contract clause cases, has never upheld a statute prohibiting or altering contractual obligations that the parties had performed. For example, *Blaisdell* did not concern mortgage foreclosures that had already occurred, but only prevented future foreclosures for a two-year period.[71] Similarly, in *Stone v. Mississippi*,[72] although future lotteries were prohibited, the sellers of lottery tickets were not required to return purchasers' money.

Regarding the statutes upheld in prior cases against contract clause attacks, it may well be that, as a result of a statutory prohibition of future actions required by existing contracts, specific contracts were voided by subsequent court action. But the purpose and the direct effect of the legislation reviewed in those cases was to protect the public from anticipated *future* harm. By contrast, that portion of chapter 598 that makes existing contracts voidable is designed to compensate for *past* ills incurred as a result of *completed* contractual performances. With respect to the scope given a state's police power, the present case thus goes further than other cases in the area.[73] Yet, although expanding the police power to allow for the modification of executed contrac-

71. Home Building and Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).

72. 101 U.S. 814 (1879).

73. The word "retroactive" itself causes some confusion, because it is used in two different contexts in legal analysis. In one set of circumstances it refers to the effect of laws on events which have terminated before legislative action. In the second context, retroactive laws affect rights which were received in the past, but, in the absence of legislation, would not reach fruition for some time in the future. Both types of retroactive legislation have been disfavored, but, as has been shown, courts have allowed some retroactive legislation of this second type. *See* Slawson, *Constitutional and Legislative Considerations in Retroactive Lawmaking*, 48 CAL. L. REV. 216, 216-20 (1960).

The present case involves the first type of retroactive legislation which has not received even the small amount of validity given to legislation of the second class.

tual provisions poses significant additional questions concerning existing limitations on the police power, the rationale relied upon by the Nevada Supreme Court to make this extension was simply a restatement of the rationale developed to permit a state to alter future contractual actions. The court provided no new justifications.

B. Public or Private Welfare?

One of the most significant limitations on a state's ability to constitutionally impair contracts is the requirement that the impairing legislation promote the public welfare and not merely the welfare of one of the parties to a contract.[74] Unquestionably, the regulation of pyramid sales contracts is an "end which is in fact public;" however, as previously noted, that purpose was accomplished by making future contracts illegal. The provisions making existing contracts voidable aids only the parties to the contract that had succumbed to Koscot's inducements by giving them a simplified legislative remedy to be used in the place of existing judicial remedies.[75]

It could be argued that legislation that helps even a small number of parties to existing contracts is an "end which is in fact public." Some support for this position can be found in the fact that the law upheld in *Blaisdell* significantly benefited mortgagors. Nevertheless, the quantum of public interest involved in insuring that large numbers of individuals do not lose their homes and farms, and hence their very livelihood, is significantly greater than that involved in facilitating a few individuals to recover their investment without going to court. Furthermore, the statute upheld in *Blaisdell* was designed to preserve the agricultural sector of the state's economy and not merely to provide a simplified remedy.[76] A review of post-*Blaisdell* decisions reveals that statutes upheld against contract clause attacks have consistently benefited the public generally and that any benefit accruing to the parties to the contract was incidental to the promotion of the general public welfare. Since modification of executed contractual provisions—part of the chapter 598 scheme—is by its very nature concerned with past harm, only the contracting parties will be significantly affected, and the public interest involved

74. Treigle v. Acme Homestead Ass'n, 297 U.S. 189 (1936).

75. *See* notes 10-14 and accompanying text *supra*.

76. 290 U.S. at 422-23, 437, 446.

when the legislature is not acting to prevent future harm is minimal.

C. *Retroactivity*

Assuming, however, that the public welfare requirement is met, retroactive voidability can be challenged on another basis. As was demonstrated earlier, the legislative history of the contract clause shows that it was intended to function much like the *ex post facto* clause, limiting the effect of legislation to acts which are yet to be performed.[77] Furthermore, the initial Supreme Court decision interpreting the contract clause, *Fletcher v. Peck*,[78] held that legislation could not be retroactively applied to invalidate earlier state grants of land even though those grants were obtained by bribery. Thus, the retroactive voidability provisions of chapter 598 appear to violate a fundamental touchstone of the contract clause.[79]

Since the present case involves a contract that is, technically speaking, partially executory (Koscot would have a continuing obligation to supply cosmetics and to pay commissions earned from product sales), it might be distinguished from *Fletcher v. Peck*. It is doubtful, however, that anyone would desire to continue selling Koscot's cosmetics absent the possibility of earning income from position-selling—a possibility destroyed when pyramid schemes were made illegal. As a practical matter, therefore, the executory aspect of the contract is a phantom, and the basis for distinguishing *Fletcher v. Peck* must be deemed unavailable. In any event, the *contested* retroactive provision of chapter 598 deals with actions and rights secured in the past, and exemplifies the civil application of an *ex post facto*-like measure in a manner contrary to the spirit and purpose underlying the drafting of the contract clause.

D. *Alternative Theories of Recovery*

Finally, the statute goes further than necessary to achieve the desired result of providing those who have been defrauded

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77. *See* note 24 and accompanying text *supra*.

78. 10 U.S. (6 Cranch) 87 (1810).

79. Expressing his belief that the *ex post facto* and contract clauses had similar purposes, Marshall stated that:

> This rescinding act would have the effect of an *ex post facto* law . . . . This cannot be effected in the form of an *ex post facto* law, or bill of attainder; why then is it allowable in the form of a law annulling the original grant?

Id. at 138-39.

with a reliable means of recovering from their mistakes.[80] Since chapter 598 eliminated the possibility of making money from future sales, and since that possibility was in fact the most significant benefit provided by Koscot's contracts, existing contracts could be judicially voided on a theory of frustration of purpose. In addition, the court found that Koscot's operations were "nothing but a fraudulent scheme,"[81] indicating that a theory of fraudulent misrepresentation pleaded in the alternative would also be successful.

One conceivable justification might be presented to overcome these problems with the court's decision: the retroactive application of chapter 598 simply allows the parties to do in one step what would normally take two. As previously mentioned, existing contracts similar to Koscot's can be rescinded on a frustration of purpose theory, since future pyramid contracts are prohibited. As a result, the provision making existing contracts voidable, as a practical matter, does no incremental damage to the sanctity of contracts and only makes it possible to omit an unnecessary and perfunctory trip to the courthouse.

If it were possible to limit the holding of the case to those situations where contemporaneous legislation prohibiting future conduct would *invariably* result in the invalidation of existing contracts because of fraud or frustration of purpose, such an argument would be supportable. A judicial determination that invalidation would inevitably occur in every imaginable case, however, simply may not be possible. For example, in the pyramid sales area, a few pyramid sales schemes, primarily found in the Midwest, have been found to be legitimate marketing methods in that the pyramiding is controlled and commissions from product sales do in fact provide the fundamental source of income.[82] In such cases, a frustration of purpose claim might not be supportable; the contract would thus be immune from rescission, and a statute making existing contracts voidable would cause some incremental harm to the interests that the contract clause was designed to protect. Nevertheless, since most of the pyramid schemes operating in the western states are clearly "nothing but a fraudulent scheme," it is conceivable that a court reviewing a statute chal-

80. *See* note 51 and accompanying text *supra*.

81. 530 P.2d at 112.

82. *See Multi-Level, supra* note 4, at 358, 390-93, where the author states that controlling the abuses of pyramid schemes by intelligent legislation would be a practical alternative to outlawing such plans altogether, because a few pyramid plans are not fraudulent.

lenged under the contract clause could accurately determine that all pyramid contracts in a specific jurisdiction would ultimately be invalidated in any event.

IV. CONCLUSION

Absent a determination, however, that all contracts embodying a pyramid sales scheme would ultimately be voided under traditional contract principles, the instant case must necessarily be viewed as stretching the police power rationale beyond its current limitations. That extension can only be justified if one is prepared to do what the court in the present case refused or failed to do expressly. Sufficient public interest would have to be found in the fact that only a few individuals who are parties to existing contracts are benefited. The pervasive idea that legislatures are to enact laws which cover future conduct only would have to be rebutted,[83] and the legislative history of the contract clause would have to be rewritten. Further, one would need to rationalize the fact that the retroactive provisions of chapter 598 or statutes like it do little to promote the *general* welfare and are not necessary to provide defrauded parties with an adequate remedy.

The right of contract is a constitutionally-guaranteed right. While the state necessarily has power in certain circumstances to modify contractual terms to protect the public, this power should be kept in check so as not to seriously impair a doctrine of long-standing constitutional authority. In particular, the constitutional limits placed upon the legislature's power to impair contractual obligations ought not to be diluted beyond the present limits which permit only the reasonable prohibition or alteration of contractual duties to be performed in the future.

83. *See generally* Smead, *The Rule Against Retroactive Legislation: A Basic Principle of Jurisprudence*, 20 MINN. L. REV. 775, 776-94 (1936).