

## CASE 4

# Multilevel Marketing Under Fire: Herbalife Defends Its Business Model

## INTRODUCTION

Herbalife International is the third largest direct-selling, multi-level marketing company in the world. Its product line consists of weight-management and nutrition products. These products are not sold in retail stores; rather, consumers interact with independent contractors to order the products. Herbalife's headquarters are located in Los Angeles, California, and they operate in several countries throughout the world. Herbalife is a publicly traded company that is both loved and hated by investors and consumers.

This case first discusses the history of the company from its founding to its present status, followed by a description of the types of products Herbalife offers. Then we will get into a discussion of multilevel marketing and the role of independent contractors in the direct-selling model. Next will be a discussion of pyramid schemes and why they are often confused with the multilevel marketing model. We then examine Herbalife to determine whether it is a pyramid scheme.

We will illuminate the role of hedge fund investor William Ackman in the backdrop of Herbalife's business model and show his contentions with the company and some of the criticisms against him. The case shows that while Ackman's accusations may be the most widely known, there are other accusations (mostly referring to pyramid schemes) that Herbalife has had to face over the course of its existence. The case ends with a brief overview of Herbalife's social responsibility program and conclusions.

## HISTORY

Herbalife is a company that focuses on nutrition, weight-management, and personal care products with independent contractors in more than 90 countries. Mark Hughes founded the company in 1980 out of a

desire to create a safe alternative to other weight-loss products. Herbalife's first sales were made from out of the trunk of Hughes' car in Los Angeles, California, and two years later the company reached \$2 million in sales. Herbalife was taken public in 1986 on the NASDAQ stock exchange. Since then, Herbalife has become a multi-billion dollar global company.

In 1999, Hughes planned to take the company back to the private sector by purchasing all of its remaining shares, but this attempt was stopped as investors sought legal action. The next year, Mark Hughes died unexpectedly at the age of 44. Christopher Pair, who was Herbalife's former Chief Operating Officer (COO), then became President and Chief Executive Officer (CEO) of the company. His reign at Herbalife was cut short as he stepped down one year later.

An Internet retailer, Rbid.com, made a bid of \$173 million to acquire Herbalife, but the Mark Hughes family Trust rejected the offer. In 2002, the investment firm J.H. Whitney & Co. purchased the company along with another investor and took it back to the private sector. However, in 2004, Herbalife went public once again and was traded on the New York Stock Exchange. Michael O. Johnson has been Herbalife's CEO since 2003. The company currently employs 6,200 people and has almost three million independent contractors throughout the world.

## PRODUCTS

Herbalife sells weight-management, targeted nutrition, energy and fitness, and personal care products, all intended to support a healthy lifestyle. Additionally, the firm offers a set of core products: Formula 1 Nutritional Shake Mix is a protein and fiber shake with several minerals, vitamins, and nutrients offered in seven flavors; Formula 2 Multivitamin Complex is a multivitamin that contains over 20 vitamins, minerals, and herbs

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essential to healthy living; and Formula 3 Cell Activator promotes absorption of minerals and vitamins while improving energy levels. These three core products are at the heart of the Herbalife product line and serve as the baseline for nutrition and weight management goals.

The weight-management line consists of a variety of Formula 1 protein shakes, supplements, weight-loss enhancers, protein bars, and snacks, all serving the purpose of helping customers attain their weight goals. There are three weight-management program sets, each with a combination of shakes, supplements, and enhancers designed for different types of weight management needs. Each component of this line can also be purchased separately. The Personalized Protein Powder and the Protein Drink Mix offer an alternative to traditional meals while providing energy and curbing hunger cravings, whether consumers just want to lose or maintain their weight or build muscle mass. The enhancers and supplements offer a mix of vitamins, minerals, herbs, and nutrients. For example, Prolessa Duo and Snack Defense work to stave off hunger in order to control weight gain and help the body process sugars more efficiently. Other enhancers, such as Total Control, boost metabolism, energy, and alertness, while Thermo-Bond helps the digestive system. Cell-U-Loss helps the body eliminate unnecessary water and rejuvenate skin with its combination of herbal extracts. An assortment of healthy snacks and beverages are also offered in this line, such as protein bars, soups, teas, and soy nuts.

Targeted nutrition products include dietary and nutritional supplements that contain herbs, vitamins, minerals, and other natural ingredients to strengthen specific areas of the body that tend to be problematic for most people. For example, Tri-Shield helps the heart stay healthy by maintaining good cholesterol levels and providing antioxidants; Ocular Defense Formula and Joint Defense Advanced offer support to the eyes and joints of aging adults; Active Fiber Complex and Aloe Vera Powder helps those with digestive issues; RoseGuard and Schizandra Plus strengthen the liver, immune system, and cells; and Relax Now and Sleep Now, which are part of the stress management line, serve to promote ease and rest. Herbalife also offers nutrition products specifically for women, men, and children.

Herbalife also provides energy and hydration drinks for those engaged in sports and fitness activities. Customers can choose from an assortment of beverages such as Liftoff, a fizzy drink mix that enhances clarity and rehydrates the body, or they can choose

supplements such as N-R-G Nature's Raw Guarana Tablets, which also promote mental clarity. Herbalife24 is the sports drink line that includes formulas for hydration, prolonged endurance, restoration of strength, and recovery.

Personal care products include skin cleansers, moisturizers, lotions, shampoos, and conditioners from a variety of different lines. Herbal Aloe Strengthening Shampoo and Conditioner, hand and body wash, cream, soothing gel, and bath and body bar is claimed to improve the look and feel of hair and skin. The Multivitamin line is similar to taking a multivitamin every day and includes a cleanser, toner, moisturizer, sunscreen, eye gel, and cream infused with vitamins for skin. Radiant C scrub cleanser, skin booster, and body lotion claim to renew and rehydrate the skin with a concentration of vitamin C. Other items include anti-aging products and fragrances for men and women.

## MULTILEVEL MARKETING

Direct selling is the marketing of products to ultimate consumers through person-to-person sales presentations at home or online. People are attracted to direct selling for many reasons. Some are passionate about the product and want to promote the company. Others want to receive a discount on their personal orders. Many find working as a direct seller to be a flexible, part-time opportunity for extra income. Additionally, some independent contractors simply enjoy the social aspect of direct selling. Within the direct selling model are two compensation models: single-level marketing and multilevel marketing. Single-level marketing is when a contractor makes a commission for arranging a sale or earns a margin as a reseller. Multilevel marketing, sometimes called network marketing, is a compensation wherein contractors earn income from their own sales of products as well as commissions from sales made by those they have recruited. Sales are never forced, as a legitimate company does not force downline sales.

However, it is not necessary for contractors to recruit other individuals in order to earn money. It is a choice made by the contractor if they want to increase their earnings by making a commission from the sales of their recruits. Approximately 71–72 percent of Herbalife members are single-level distributors, meaning they do not sponsor other Herbalife distributors. This means that these Herbalife members buy products from the company at a discount and have the complete

TABLE 1 Top Ten Direct Selling Companies

	Company Name and Product Line	2013 Revenue (USD Billions)
1	Alticare (Amway) Nutrition, Beauty, Bath and Body, Home, Jewelry, Food and Beverage, Fragrances	\$11.8
2	Avon Cosmetics, Skin Care, Fragrance, Personal Care, Hair-Care, Jewelry, Gifts	\$9.95
3	Herbalife Nutrition, Weight-Loss Management, Personal Care	\$4.80
4	Vorwerk Household Appliances and Cosmetics	\$3.70
5	Mary Kay Cosmetics, Skin Care, Body and Sun, Men's Products, Fragrance Gifts	\$3.60
6	Natura Cosmetics	\$3.20
7	Nu Skin Skin Care	\$3.18
8	Tupperware Food Storage and Preparation, Cookware, Serving Items, Cosmetics, Beauty Products	\$2.67
9	Belcorp Beauty Products	\$1.96
10	Oriflame Cosmetics	\$1.95

Source: Direct Selling News, "2014 DSN Global 100 List," *Direct Selling News*, 2014, [http://directsellingnews.com/index.php/view/2014\\_dsn\\_global\\_100\\_list](http://directsellingnews.com/index.php/view/2014_dsn_global_100_list) (accessed May 22, 2014).

freedom to determine pricing as well as in all decisions involving their final customers. Since many of these members simply want a discount on these products, they may not be as interested in making profits but simply enjoy the opportunity to receive these discounts. Furthermore, rewards are not given simply for recruiting another contractor. See Table 1 for the top ten global direct selling companies.

Another aspect of multilevel marketing involves internal consumption, which is the purchasing of products at a discount from the firm for the contractor's own use. Most retailers provide internal consumption incentives by offering discounts to employees who purchase products. Department stores, automobile manufacturers, and airline companies provide incentives such as discounts that encourage internal consumption. Many people become resellers to get discounts on products for their own use. Therefore, the claim that internal consumption is unacceptable is refutable on the basis that the vast majority of companies selling consumer products encourage their employees or independent

contractors to purchase their products. Many individuals committed to these products believe in the brands for their own personal use and want to 'spread the word' by creating a broader sales and communication network. Some do not even necessarily care about making a profit from the business. This is a common and legal approach for direct selling products around the world. In fact, most direct selling companies use multilevel marketing. At Herbalife, there is no limit to the number of levels of recruits.

Despite the legitimacy of multilevel marketing, China has restricted direct selling to single-level marketing only. China believes multilevel marketing is linked to fraudulent activities such as pyramid schemes because of the assumption that discounts are used to force internal consumption. China allows direct selling companies to do business within their borders if they sign a contract saying they will not employ the multilevel marketing aspect of direct selling. Instead of having independent contractors recruit others, they sell their products from retail stores.

## INDEPENDENT CONTRACTORS

There are nearly 3 million independent contractors of Herbalife products, and all of them personally use these products. Many are attracted to the low startup cost of selling Herbalife. The startup cost for a part-time contractor is \$57.75 for a kit. For this price, they will receive the mini-International Business Pack, which includes forms, applications, a tote bag, and samples of various Herbalife products. Informational and training materials educate the contractor on using and retailing the products, business basics, and how to build a sales and marketing plan. Alternately, if a contractor wants to work full-time, they can purchase the full International Business Pack for \$89.55. This pack comes with all of the materials that the mini-pack offers but with more product samples and information on how to run your business. There is no fee to join, and the only money spent is for the value of the kit.

Contractors enjoy discounts off products, ranging from 25–50 percent depending on the level of contractorship. Herbalife resellers often purchase the products themselves and then resell them directly to buyers; however, it is possible for the reseller to make the sale and get the product directly from Herbalife. Resellers can resell the products at any price they want. Each Herbalife product has a certain number of Value Points, and the number of Value Points a contractor accumulates determines what level of contractorship he or she has. Personally purchased Value Points are awarded based on the volume that a contractor purchases from Herbalife using his or her Herbalife identification number. Royalty Override Points are accumulated based on the Total Volume of products sold by personally sponsored supervisors that the reseller has recruited.

To go from basic distributor to the Senior Consultant level, a Herbalife member must have accumulated a minimum of 500 Volume Points in one month. To be promoted from Senior Consultant to Senior Contractor, a contractor must accumulate at least 1,000 personally purchased Value Points in one order. Levels after that include Qualified Producer (2,500 Volume Points accumulated in 1–3 months), Supervisor (4,000 Value Points in one month, 2,500 Value Points in each of two consecutive months, or 5,000 personally purchased Value Points within 12 months), and World Team (2,500 Value Points in each of 4 consecutive months, 10,000 Volume Points at 50 percent in one month, or 500 Royalty Override Points in 1 month). Once a contractor reaches the Supervisor level, the product discount is increased from 25 to 50 percent and a profit can be made on sales to other contractors, which can reach up to 5 percent.

In the event that a contractor no longer wants to sell Herbalife products, the company will buy back the remaining inventory the contractor has on hand. Herbalife goes beyond the Direct Selling Association's ethical guidelines for buying back products by reimbursing the distributor for everything that he or she paid for initially (100 percent buyback policy). The company also discourages contractors from inventory loading, which the Federal Trade Commission (FTC) has defined as a practice requiring a contractor to make a large purchase of a large amount of nonreturnable inventory. To renew their membership, contractors pay a \$10 annual membership fee to Herbalife.

The Herbalife business model has succeeded due to their excellent products and customer support. Most independent contractors do not have a physical store location but practice direct selling from home. They are not employees but business people who choose how they want to operate. There are strict company policies and legal requirements that contractors must abide by that regulate product information, sales techniques, advertising, lead generation, social media, and related issues. For instance, members can sell online, but there are advertising restrictions for online sales. The products cannot be searchable online by their price, and the only way a potential buyer can get more information is by getting a password from the reseller. This facilitates a conversation between the buyer and reseller, allowing a relationship to develop even through online transactions. Contractors are not able to resell products on auction sites or in retail stores (excluding China).

Herbalife's selling policies are guided by the principles of the World Federation of Direct Selling Association (WFDSA) and the Direct Selling Association (DSA) in the United States. The WFDSA promotes ethical practices in direct selling globally through advocacy and strong relationships with government, consumers, and academia. The DSA also emphasizes ethics and requires that members adhere to their code of ethics (See Table 2). Herbalife is a member of the DSA and abides by their code of ethics. This code of ethics recognizes the importance of a fair and ethical approach to direct selling, since direct selling requires sensitive and personal one-on-one interaction that can lead to undue pressures placed upon consumers. The code has no tolerance for deceptive or unlawful practices regarding recruits and customers; requires that salespeople provide accurate and truthful information about the price, quality, promotion, etc. of the products; illuminates and enforces the need for a clear record of the sales made by contractors; necessitates that warranties and

**TABLE 2** Direct Selling Association Code of Ethics**As a consumer you should expect salespeople to:**

- Tell you who they are, why they are approaching you, and what products they are selling.
- Promptly end a demonstration or presentation at your request.
- Provide a receipt with a clearly stated cooling off period permitting the consumer to withdraw from a purchase order within a minimum of three days from the date of the purchase transaction and receive a full refund of the purchase price.
- Explain how to return a product or cancel an order.
- Provide you with promotional materials that contain the address and telephone number of the direct selling company.
- Provide a written receipt that identifies the company and salesperson, including contact information for either.
- Respect your privacy by calling at a time that is convenient for you.
- Safeguard your private information.
- Provide accurate and truthful information regarding the price, quality, quantity, performance, and availability of their product or service.
- Offer a written receipt in language you can understand.
- Offer a complete description of any warranty or guarantee.

**As a salesperson, you should expect a DSA member company to:**

- Provide you with accurate information about the company's compensation plan, products, and sales methods.
- Describe the relationship between you and the company in writing.
- Be accurate in any comparisons about products, services or opportunities.
- Refrain from any unlawful or unethical recruiting practice and exorbitant entrance or training fees.
- Ensure that you are not just buying products solely to qualify for downline commissions.
- Ensure that any materials marketed to you by others in the sales force are consistent with the company's policies are reasonably priced and have the same return policy as the company's.
- Require you to abide by the requirements of the Code of Ethics.
- Safeguard your private information.
- Provide adequate training to help you operate ethically.
- Base all actual and potential sales and earning claims on documented facts.
- Encourage you to purchase only the inventory you can sell in a reasonable amount of time.
- Repurchase marketable inventory and sales aids you have purchased within the past 12 months at 90 percent or more of your original cost if you decide to leave the business.
- Explain the repurchase option in writing.
- Have reasonable start-up fees and costs.

Source: Direct Selling Association, "Summary Version of the DSA Code of Ethics," *Direct Selling Association* <http://www.dsa.org/ethics/shortcode/> (accessed July 9, 2013).

guarantees be fully acknowledged; requires salespeople to clearly identify themselves to customers and maintain the confidential information of their customers; has no tolerance for pyramid schemes; and provides guidelines on inventory purchases, earnings reporting, inventory loading, paying fees, and training.

A 2013 survey conducted by Nielsen, a reputable global information measuring company, showed (without interference from Herbalife) the number of end-consumers Herbalife serves. The study, which took place online over the course of two months, sampled 10,525 consumers and was balanced in terms of demographics, income, and geographic placement. The results indicated that 3.3 percent of the general population made a Herbalife purchase sometime over the past three months. This percentage of the population translates into 7.9 million customers, which does include Herbalife's contractors. According to the data, however,

the number of contractors is approximately 550,000, indicating that the number of end users is higher than the number of independent contractors. Additionally, the study showed that those who made a purchase in the last three months tend to make Herbalife purchases consistently (approximately every two months), and that the most popular products are those having to deal with weight management (95 percent of those who made a purchase in the last three months).

One of the biggest arguments against Herbalife is its line commissions. Currently, Herbalife contractors can earn commissions on what every recruit below them buys or sells. There are no restrictions on the number of levels of recruits that contractors can earn a commission on, unlike some other multilevel marketing companies.

## PYRAMID SCHEME

There are four defining characteristics of a pyramid scheme. The first, which is dictated by the FTC, is that consumers or investors are promised large profits based primarily on recruiting others to join their program. The promise is not based on profits from any real investment or real sale of goods. Second, according to the Securities and Exchange Commission (SEC), the promise of high profits rests on nothing more than a consumer or investor handing over their money and convincing others to do the same. Third, the Federal Bureau of Investigation (FBI) warns that pyramid schemes can be in the form of marketing and investment frauds when an individual is offered a contractorship or franchise to market a particular product. The real profit is earned not by the sale of the product but by the sale of new contractorships. Lastly, the California Department of Justice identifies the difference between a pyramid scheme and a legitimate multilevel marketing plan. In a multilevel marketing model, money is only made through the eventual retail sale of the product to an end user. In an illegal pyramid scheme, the participants at the top of the pyramid earn money when new members are recruited. Each new member is then required to recruit new participants. As this process goes on, the possible pool of participants shrinks, making it hard for those at the bottom to gain a return on their investment. A pyramid scheme will ultimately collapse due to a lack of new recruits and is therefore unsustainable. Another important point is that a pyramid scheme that seems to offer a product will have little to no market value. The recruits are being sold on an idea or a model.

Pyramid schemes can be hard to identify clearly, but the FTC has warned consumers about two red flags.

The first is inventory loading, which looks similar to internal consumption because it encourages large-scale purchases of nonrefundable products by a distributor. Not only is inventory loading a red flag but also illegal. The second is a lack of retail sales. If a supposed business has both of these characteristics, it is possible that it is a pyramid scheme and not a business at all. Another way of detecting a pyramid scheme is by examining the intention of the buyer. If the buyer purchased a product he or she really did not want just to participate, it is an indication that it could be a pyramid scheme. It is for these reasons that some direct selling businesses using the multilevel marketing compensation method can appear to be pyramid schemes. Because Herbalife sells not only their nutrition products but also a business opportunity, the firm has been accused of running a pyramid scheme.

## IS HERBALIFE A PYRAMID SCHEME?

In 2012, Herbalife was accused of being an elaborate pyramid scheme by hedge fund manager William Ackman. Ackman had bet \$1 billion in a short sale off Herbalife's stock. Short selling occurs when an investor sells shares borrowed from a lender (e.g. a broker) in the belief that the stock will decrease. The investor takes the money for the stock sale, but eventually must re-purchase the stock and return them to the lender. If the stock has gone down, the investor makes a profit. However, if it has gone up, the investor loses money because he or she is buying back the shares at a higher rate than the price at which they originally sold them.

Ackman's accusations against Herbalife included the following: 1) the majority of contractors for Herbalife lose money, 2) Herbalife pays more for recruiting new contractors than selling actual products, and 3) only the top 1 percent of contractors earn most of the money. The accusation is a result of the confusion that comes from the way their earning structure operates. Ackman argued that Herbalife recruits contractors under false beliefs that they can earn the income of those at the top by selling the product and that the real money comes not from selling products but from recruiting other contractors. His reasoning is that contractors earn rewards for every member they recruit, and every member the recruits recruit. However the term "rewards" is misleading. In a multilevel marketing compensation method, contractors earn a commission on the sales of their recruits.

The term "rewards" implies that there is some amount of money given for simply recruiting. However, this is not how Herbalife pays its contractors. Herbalife operates a little differently than other multilevel marketers in that most have a cut-off on what level of recruits a contractor can earn compensation from. Herbalife does not have a cut-off (although the average is approximately six levels downline). While this characteristic differs from other multilevel marketing companies, it is not enough to classify Herbalife as a pyramid scheme.

Another contention of Ackman's is that when an individual goes to purchase Herbalife products, distributors try to convince him or her to become a recruit rather than remain a customer. He argues that the only thing keeping the company running is new recruits, and it will soon run out of available people to recruit into the business. Ackman alleges that Herbalife enters new countries after the current pool of recruits in a particular country is exhausted.

On the other hand, many consumers and organizations buy and use Herbalife products and see them as high-quality and credible. For example, Los Angeles fire and police department officers use Herbalife products in their fitness centers. Herbalife products have even been adopted by some Chinese Olympic teams. Additionally, because the number of end users is larger than the number of independent contractors, supporters of Herbalife claim it cannot possibly be operating a pyramid scheme. This supports the fact that Herbalife uses a valid and successful business model, which is producing profits directly related to product sales and allowing them to expand globally.

Ackman, however, has made claims to invalidate these numbers. He claims that the survey measuring the number of contractors versus end consumers contradicts two others that were released by the company. He also states that Herbalife refuses to make the details of its recruiting process public knowledge so it can be scrutinized. Ackman's company has accused the survey sample of being too small, making the results overly optimistic. He takes issue with the fact that there are not enough specifics in the survey (prices consumers paid and an itemized breakdown of the products purchased).

Herbalife has also been accused of issuing false accounting statements. There has never been any legal accusation about the recording of sales. According to allegations, products are sold to contractors and are shown as retail sales on the company's revenue. The company does not always trace whether the product was consumed by the contractor (i.e., internal consumption) or to whom the contractor sold the product. The criticism is that the company should not be making

money off the contractors but should only record revenues made from end users. Those who criticize internal consumption by contractors or employees within a company fail to recognize that this is an acceptable practice. Coca-Cola has 100 percent internal consumption because all of its products are sold to resellers. Costco also has 100 percent internal consumption because all of its products are sold to Costco members. This shows that the percentage of internal consumption is not by itself enough to indicate a pyramid scheme. There has never been major criticisms of companies encouraging internal consumption except with the direct selling, multilevel marketing compensation model.

Second, sometimes when new contractors are recruited, they need to buy products that they can consume themselves or sell to others. These practices have caused suspicion among Herbalife's critics. On the other hand, a contractor is only required to buy more products after the initial purchase if they want or need it for personal or business purposes. Once individuals sign up to be contractors, they indicate if they want the products for personal use or to make available for sale. If contractors have recruits under them, they have the opportunity to earn commissions based on the sales of those recruits. On the other hand, if the contractors do not care about the commission, they do not have to purchase anything more. In the case of Herbalife, the amount of products contractors are required to purchase is lower than many other multilevel marketing businesses.

There is also a criticism that a large number of contractors are not successful in selling their products. The ease of entry and extremely low cost of becoming a contractor makes it possible for those with little experience to enter the business. Even if they are not successful at direct selling, the cost of entry is less than \$100 and they still have products that they can consume. Herbalife's records show that only 1 percent of its registered contractors will make \$100,000 from the business in their lifetime. Ackman has argued that the numbers Herbalife reports are false. He estimates their retail sales to be only 3 percent of their revenue, while the rest is made by recruiting practices. Ackman also implied that Herbalife saturates markets, requiring it to get most of its sales from new, undeveloped markets.

These discrepancies can be explained when the types of contractors are analyzed. There are those that sign up only to get the contractor's discount on the product because they want the product for personal use; those who only want to sell the products as a source of additional income; and those that want to sell as a full-time business opportunity. Furthermore, every kind of direct

selling business requires a large amount of effort to make a good profit. Even with businesses like Herbalife, if a contractor wants to make a living from distributing, relationships with customers must be maintained, and relationships with recruits must be maintained to encourage them to make as many sales and new recruits as possible. Many who begin in any direct selling business are either not willing or lack the business knowledge to put in that much effort. Those who sign up for this opportunity as a side job only work part-time or less, depending on how much extra money they want to make. In terms of market saturation, it would appear that Ackman is incorrect. Herbalife receives approximately 90 percent of its sales from markets in which it has done business for at least ten years, and growth in mature markets is growing by double digits.

Herbalife has defended itself against allegations of being a pyramid scheme. It responded to Ackman's charges in January 2013. However, the company's stock fell 43 percent four days after Ackman's accusations to \$24.24, which was the largest drop the company had seen in several months. In response to Ackman's lobbying efforts, Herbalife hired a lobby team consisting of Glover Park Group and the Podesta Group.

## CRITICISM AGAINST WILLIAM ACKMAN

As mentioned earlier, in accusing Herbalife of operating a pyramid scheme, William Ackman bet against their stock to the amount of \$1 billion. Initially, the accusations caused Herbalife's stock to drop, benefiting Ackman's company because of his short sale. Ackman had pledged to give any profits from the short sale to charity, but to many people the short sale and subsequent accusations appeared to be a serious conflict of interest.

Another issue involved letters from supposed victims of Herbalife's deceptive practices. Because one of Ackman's contentions is that Herbalife targets minorities, Ackman's company has paid civil rights organizations \$130,000 to collect names of people who were victims of Herbalife. However, the Nevada Attorney General found issues with some of these letters. Three of the letters from nonprofit groups signed by Hispanic community leaders were identical, and none of the leaders could identify any Herbalife victims by name. Other attorneys general have had similar experiences. Some of the leaders who had allegedly written the letters later denied they had written them. This could represent questionable conduct to encourage regulators to act.

Shortly after Ackman's accusations, another investor, Carl Icahn, came to the defense of Herbalife and became a majority shareholder and board member. This helped boost investor confidence in Herbalife, and their stock began to increase. This was bad news for Ackman when he was forced to cover his short sale. He took a loss on 8 million shares of stock. However, the state of Herbalife was still uncertain amid accusations, investor uncertainty, and Herbalife's strong stance that it was not operating a pyramid scheme. Pyramid schemes take some time to reveal themselves, so it was just a matter of waiting until Herbalife either crumbled or succeeded before anyone could be certain about the future of the company.

An article in the March 15, 2014, issue of the *Economist* as well as *The New York Times* provided a critical assessment of Ackman's attempts to use state-of-the-art lobbying in Washington to support his \$1 billion short bet against Herbalife. Ackman has been at the heart of well-executed lobbying, although he claims to have spent only \$264,000 on his lobbying campaign. On the other hand, Ackman's company's lobbying budget was seven times that much. According to the *Economist*, Ackman sees himself as a moral crusader against Herbalife, but his critics see him as simply a "greedy billionaire who is now exploiting America's newly laissez-faire attitude to political spending in pursuit of a big financial payday." Ackman has gained support from one U.S. senator and a U.S. Congressperson who have asked for the FTC to investigate Herbalife. The FTC did begin an investigation, and Herbalife claims that they welcome the opportunity to vet their business model and put these attacks behind them.

## THE CONTROVERSY CONTINUES

Despite the company's recent success, the allegations continue. Special interest groups such as the Hispanic Federation and the National Consumers League are taking issue with the company and urging the FTC to investigate Herbalife's operations. Not only are they continuing the claim that Herbalife is operating a massive pyramid scheme but they are furthering the argument to say that the company is targeting vulnerable groups including low-income Hispanic immigrants and low-income African Americans. The allegations against Herbalife include aggressive recruiting techniques, promises of getting rich with minimal work, and taking advantage of people with little or no business experience.



The claims arose from the proliferation of nutrition clubs that have been established in Latino/Hispanic communities in Southern California. Nutrition clubs involve community members who pay a membership fee to discuss health issues and consume Herbalife products in a social setting. The popularity of these nutrition clubs originated in Mexico, which is where most of the immigrants in Southern California immigrated from. Herbalife claims that the nutrition clubs started arising in these areas because Hispanics saw how successful they were in Mexico and wanted to import the idea to the United States. Others claim that these clubs are harming the community because they turn out to be too costly for those who run them and end up losing more than they bargained for. Congresswoman Linda Sanchez, who represents Southern California, has written a letter to the FTC asking the agency to investigate Herbalife. She cited the intense media coverage and outreach from special interest groups and constituents as reasons for the FTC to investigate the company. Similar claims also abound in New York. New York City Councilwoman Julissa Ferreras has also written to the FTC advocating for an investigation.

Desmond Walsh, President of Herbalife, maintains that the company does not target specific demographics and that the rise of nutrition clubs in Latino/Hispanic communities is a result of immigrants seeing the business opportunity and importing the clubs from Mexico. Another issue with these clubs is that owners are operating them out of their homes and making and selling shakes. The Los Angeles Department of Health has closed some of these clubs as it is illegal to make and sell food items out of one's home. These clubs have to follow the same regulations as restaurants, requiring permits and other sorts of time-consuming and expensive governmental red tape. Critics claim that Herbalife does not adequately train their contractors in areas such as business and laws, so they are destined to fail. Herbalife, on the other hand, refutes those claims and states that they encourage their contractors to abide by their local laws.

In February 2013, it was reported that Hispanics make up 60 percent of Herbalife's customer base. One reason may be because they are good at direct selling due to their large network base and relationship building tendencies. The SEC is currently conducting an investigation into Herbalife's business operations.

One of their own former contractors filed a Class Action Complaint against Herbalife claiming, among other serious allegations, that the company is operating as a pyramid scheme. Some of the key allegations

provided in this particular case include undisclosed facts, such as a large majority of all contractors (approximately 71 percent) make few, if any, retail sales and are forced to self-consume the Herbalife products. Herbalife will likely continue facing similar accusations in the future and must remain proactive in addressing them.

In 2014, Ackman profiled Herbalife's top distributors and continued his lobbying in Washington to have Herbalife investigated by the FTC. The FTC announced that it was initiating a probe into Herbalife's business practices. Herbalife has responded by launching a new website, iamherbalife.com, that features dozens of positive testimonials from users of its products. One of Ackman's accusations is that the company sells a questionable product to gullible immigrants. Research shows that Herbalife sales continue to increase and that it has millions of customers who are not independent contractors or distributors using its products. While multilevel marketing compensation systems have been examined by the FTC in the past, the laws associated with pyramid schemes are considered ambiguous by some stakeholders. One of the key factors in a pyramid scheme is that there is no product sell-through, and in the case of Herbalife, they have definitively demonstrated that the sales are driven primarily by selling products to consumers.

However, the concept of internal consumption—though legitimate—continues to be questioned by regulators. The belief prevails that a large amount of internal consumption in direct selling companies indicates a pyramid scheme. In 2012 a U.S. judge ordered an organization called BurnLounge to disband and reimburse customers \$17 million after the FTC deduced that the company was operating a pyramid scheme. BurnLounge marketed itself as a way for entrepreneurs to sell digital music and earn large incomes. Participants paid to enter the scheme. Very little sales were recorded, and 90 percent of participants did not act as independent distributors selling a product.

BurnLounge appealed. They stated that the FTC did not have enough evidence. The appeal in 2014 was held by the Ninth Circuit Court of Appeals. The implications of this case for the multilevel marketing direct selling industry were significant. In the initial judgment against BurnLounge, it was ruled that sales of products to ultimate users do not include sales to participants. It was feared that a legal decision could rule that the majority of products must be sold to people outside the company's network. In other words, a majority of sales would have to be made to end consumers, with sales to

distributors not counted. This possibility could have put limitations on internal consumption.

The federal appeals court upheld the FTC's decision that BurnLounge was operating an illegal pyramid scheme. However, the ruling was viewed favorably by the direct selling industry overall because BurnLounge was determined to be a pyramid scheme due to the fact that participants had to pay to join the scheme and were mainly motivated by recruiting others into the scheme (versus selling an actual product). The biggest relief for organizations like Herbalife is that the court did not rule that commissions generated from goods sold to independent contractors were illegal. Internal consumption was defined as purchases made by distributors for personal consumption or resale, and not for buying products simply to qualify for bonuses or to get a discount. Like any other reseller, distributors purchasing products for internal consumption have the option of consuming the product or selling it to others. It would be impossible to know the exact percentage of the product being consumed by the independent contractor versus sales to consumers.

Rather than focusing upon the amount of consumption, the decision seemed to focus more upon whether the emphasis of the business involves sales of products or recruitment. Other areas of emphasis involve how these organizations calculate commissions and the importance of selling the product for the successful operation of the business. The intent for purchase is also a crucial component. If the purchases are driven by the product's value, instead of by money-making ventures, then it is most likely a legitimate operation.

Additionally, the BurnLounge decision described some tests that could indicate a pyramid scheme. Specifically, red flags include focusing more upon recruitment than merchandise, paying bonuses primarily on recruitment activity, promoting the program instead of selling the product, having participants purchase the right to earn profits through the recruitment of other individuals, developing strong incentives for recruitment, motivating package purchases by the opportunity to earn money, and making it unlikely that meaningful retail sales will occur.

Although some of these are not necessarily red flags by themselves, several of them taken together could indicate a pyramid scheme. For instance, the Court found that 95 percent of BurnLounge distributors brought premium products but only 35 percent of non-distributors did so. BurnLounge products had little value, and distributors were required to buy premium packages if they wanted to be eligible to receive

additional commissions. Because Herbalife contractors sell products of value, participants do not have to pay simply to participate, and retail sales do occur, this legal decision lends more credence to Herbalife as a legitimate business model.

## HERBALIFE'S SOCIAL RESPONSIBILITY

Herbalife is proud of its Corporate Social Responsibility program and believes it best sums up the company's top value of doing the right, honest, and ethical thing. These methods and policies relate to the directing and administering of short and long-term goals. They are put in place to ensure accountability and economic efficiency for Herbalife's stakeholders. Herbalife is proud that because of these policies they met independence criteria almost a year early and meet all NYSE-listed public company requirements for transparency.

Herbalife's business ethics allows it to uphold the highest ethical standards in the operation of the company. CEO Michael Johnson has said that its reputation is its greatest asset, and its Corporate Code of Business Conduct and Ethics reflects this. Herbalife encourages fair interactions and good judgment between any persons associated with the company and customers. There are guidelines set in place as to how contractors and employees of Herbalife should interact with suppliers, competitors, business partners, and the government. Herbalife encourages obedience to laws and sets boundaries on gifts and entertainment, describing the difference between small gifts for hospitality and bribes. The company discourages conflict of interest situations as well as insider trading and offers three methods of reporting unethical behavior through the company hotline, website, or by contacting the General Counsel. Individuals who do not comply are disciplined, suspended, or terminated. Herbalife also requires annual ethics training for all employees worldwide.

Another aspect of its Social Responsibility program includes its philanthropic efforts. The Herbalife Family Foundation (HFF) and the Casa Herbalife program, founded in 1994 by Mark Hughes, provide funding and volunteerism to charitable organizations taking care of children-at-risk around the world. HFF works to improve nutrition and help with disaster relief efforts. Herbalife has also partnered with the Global Alliance for Improved Nutrition (GAIN) and DSM Nutritional Products, a producer of vitamins and nutrition ingredients, to help deliver nutrients to women and

children around the world. This partnership is under the umbrella of GAIN's Future Fortified campaign.

Lastly, as a part of Herbalife's Corporate Social Responsibility program, it engages in Employee Wellness and Live Green environmentally conscious initiatives. The company encourages and incentivizes employees to become and stay healthy and participate in fitness activities. Such incentives include complimentary products and lower individual health insurance costs. The company has even been recognized by *Men's Fitness* magazine as "One of the 15 Fittest Companies in America." Through environmentally conscious initiatives, Live Green and the 3Rs—reduce, reuse and recycle—Herbalife makes its impact on the environment a priority.

## CONCLUSION

Herbalife has faced several allegations over the years but continues to be successful. As of 2013, the company reached worldwide net sales of \$4.8 billion, up significantly from 2012 in spite of Ackman's accusations and lobbying campaign against the company. Herbalife's stock price climbed to over \$80 a share in 2013 during the time that criticisms were being levied against the company. On the other hand, Herbalife's stock dropped after China initiated an investigation into the marketing practices of Nu Skin Enterprises and the announcement of the FTC's investigation. The stock was selling for over \$50 a share, which is still significantly higher than its early 2013 value.

The products of Herbalife are exclusively sold by nearly 2.3 million independent contractors in 90 different countries. It sponsors several professional athletes, teams, and sporting events. Additionally, the company is proud of its Corporate Social Responsibility initiatives. Herbalife is a successful company, but ethical issues will continue to ensue. Trust in business is at a low point in our society. Marketing is often seen as a part of business that is suspect. A direct selling firm receives additional scrutiny as it is focused on personal selling to distribute all of its products.

Herbalife contractors do not have the overhead expenses that a retail store with a building, fixtures, utilities, and other expenses requires. Therefore, the markup on products such as cosmetics, nutritional supplements, jewelry, and clothing may be similar in both the retail store and in direct selling. A direct selling company is a flat organization with low overhead and

compensation systems for the network of sales contractors that make the product available to final consumers. The concept of internal consumption, which exists in nearly all businesses, is considered questionable by some critics who fail to understand that there is nothing legal or unethical about internal consumption.

On the other hand, some direct selling companies have been associated with inventory loading, sometimes called garage stuffing, when sales contractors are encouraged to buy more products than they can consume or sell. This ethical breach has nothing to do with a company being a pyramid scheme just because it uses a multilevel compensation method. All businesses have compensation methods that reward sales managers and higher-level managers, including the CEO, for performance. Every business has to produce revenue, and the marketing function is exclusively in charge of developing sales.

However, companies can fight against criticism of their operations by maintaining total transparency concerning how their sales incentive models work, and there should be due diligence to ensure that sales contractors are not exploited in any way. Herbalife continues to have many loyal contractors throughout the world, showing that the firm has many supporters who believe the company is a legitimate and successful business operation.

## Questions for Discussion

1. Why has Herbalife's multilevel compensation model been confused with a pyramid scheme?
2. Describe the differences between a legitimate business model and a pyramid scheme.
3. How has Herbalife demonstrated social responsibility?

## Sources

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