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Herbalife Hears Familiar Chorus

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Herbalife Ltd. has gone far in fighting the old perception that it operates as a thinly veiled pyramid scheme. In recent years, it picked a high-profile Disney executive to be its chief executive, improved its diet and nutritional supplements, and changed the way it operates.

But it looks as if the L.A. company will have to fight again. A group of former top distributors in the midst of a nasty legal battle with Herbalife is renewing the claim that Herbalife operates as a pyramid scheme.

The allegation could be disregarded as a standard strategic countersuit – Herbalife earlier sued the group for allegedly poaching hundreds of its independent distributors to a competing business – except that the federal judge overseeing the case recently denied Herbalife’s request to throw out the pyramid scheme claim, instead ruling it should go to trial.

In fact, U.S. District Court Judge Gary Feess indicated that he sees the pyramid charges as serious.

“Herbalife’s entire business model appears to incentivize primarily the payment of compensation that is ‘facially unrelated to the sale of the product to ultimate users …’ rather than based on actual sales to consumers,” wrote Feess in his Aug. 25 ruling.

That’s significant because under federal law, multilevel marketing companies such as Herbalife must have policies that ensure distributors are selling most of the products to ultimate users and not just moving them down line to lower-level distributors.

If the claim is upheld by a jury, Herbalife’s own lawsuit against the distributors would be made moot. What’s more, the California Attorney General’s Office or local prosecutors could investigate. The company also could be forced to overhaul its business model.

“It would be a very bad day for Herbalife,” said William White, a litigator at L.A. firm Hill Farrer & Burrill LLP who is not involved in the case but reviewed the lawsuits at the Business Journal’s request.

“If found in court to have this illegal enterprise, at the very least authorities will require them to change the actions that were found illegal,” he said. “And the enforcement authorities would likely seek penalties, restitution and a number of other remedies.”

In a statement to the Business Journal, Herbalife contends that the eight former distributors are using the pyramid charges as retaliation. Herbalife claimed in a 2007 lawsuit that the former distributors violated their contracts with the company by using confidential information to recruit hundreds of Herbalife distributors to a competing company.

“The allegations are a smokescreen and are completely without merit,” said Herbalife in a statement, declining to elaborate on the suit.

On the other hand, if a jury finds that Herbalife does not run an illegal pyramid scheme, then Herbalife’s suit against the eight former distributors would continue.

“If Herbalife is successful in establishing that it is a legitimate business and its trade secrets were improperly used by the defendants, then that could conceivably lead to very high damages against the defendants,” White said.

Revamped image

The battle comes after extensive efforts by Herbalife to improve its image after a series of charges that it was more or less operating a pyramid scheme.

The company was founded in 1980 by the charismatic Mark Hughes, who was notorious for holding revival-style meetings with distributors celebrating their weight loss and product sales. Within five years, his army of door-to-door salespeople had sold enough supplements to hit $427 million in annual sales.

But the California Attorney General's Office brought a lawsuit against Herbalife in the late 1980s that required the company to change its marketing program so distributors would only profit from retail sales and would be discouraged from ordering large quantities of Herbalife products in order to qualify for bonuses.

Hughes died in 2000 of an accidental overdose of alcohol and a prescription antidepressant, a blow to Herbalife's healthful image. Soon after his death, the pyramid scheme issue returned.

A 2002 class-action lawsuit brought by low-level distributors accused the company of running a pyramid scheme.

Herbalife settled the suit in 2004, and agreed to pay $6 million to 8,700 distributors. The company agreed to several reforms, including making top distributors inform lower-level distributors that they aren't required to purchase promotional materials, a profit source for the top distributors.

Then Michael Johnson, the former president of Walt Disney International, took the helm of Herbalife in 2003. In one stroke, the company had a top manager with both a squeaky clean reputation and experience in international sales, key to the company's growth.

Not long after joining Herbalife, Johnson began updating the company's product line from its staple weight-management, nutrition and skin care products. He introduced items for fitness, endurance and children. He also added respected scientists to the company's nutrition and scientific advisory boards. (One of those scientists, UCLA biochemist Louis Ignarro, even designed a best-selling product called Niteworks based on his Nobel Prize-winning research into the circulatory system.)

Herbalife also launched a sweeping international expansion – something the company has stated in regulatory filings is a key factor in its success because of its dependence on establishing new distribution chains. Most significant was its entry in the Chinese market, where sales soared to $145 million in 2008.

Moreover, Herbalife moved its headquarters from Century City to downtown Los Angeles across from Staples Center, raising its profile among sports fans amid the ongoing renaissance of that area. The company signed on as a major sponsor of various sporting events and teams, including the Los Angeles Galaxy, the city's Major League Soccer team; it got an extra boost when soccer's biggest star, David Beckham, joined the team, wearing the team's jersey emblazoned with Herbalife's name.

While Feess' decision to revive the pyramid charges could be seen as a setback for the image-changing efforts, the company has survived them in the past.

"Herbalife has already been through those charges many years ago, and they proved their point that they weren't," said William Crookston, a professor at the USC Marshall School of Business and a multilevel marketing analyst. "Herbalife has improved itself a great deal from the difficulty it had."

Network marketing

At issue is how Herbalife sells its products: Multilevel marketing is legal, as long as it doesn't cross the line into a pyramid scheme.

To avoid being charged as a pyramid scheme, a multilevel marketing company like Herbalife must make the majority of its sales to retail users, not distributors and subdistributors.

In Herbalife's case, distributors purchase its products at a 25 percent to 50 percent discount from the suggested retail price, and then resell them to retail consumers or subdistributors.

When distributors advance up the chain, they gain the title of supervisor and earn bonuses based on sales that occur on lower levels. Distributors at the top of large distribution chains can make handsome livings.

The eight former distributors that Herbalife sued – Robert and Julia Ford, Bruce and Nancy Roth, Jeff and Kathy Orr, Dianna Thompson and Jason Fisher – live outside California – some are in Georgia, others in New York state and Oregon. The Fords, Roths and Orrs were high-earning distributors who ranked in the top 1 percent of the more than 1.9 million Herbalife distributors.

All were Herbalife distributors for at least 11 years, and earned between $200,000 to more than $2 million over the course of their distributorships. They decided to leave the company and join a competing multilevel marketing company, Melaleuca: The Wellness Co. They claim they became frustrated with Herbalife's business model.

"There were issues that made it a less attractive business opportunity than the place that they went to," said John Stephens, an attorney representing six of the former Herbalife distributors. "You have to do a certain amount of volume to get your royalty checks, and that is not required at Melaleuca."

In court documents, the former distributors' attorneys also claim that Herbalife offers lucrative rewards for recruiting new distributors, and doesn't focus on selling its products to retail users as required by federal law.

"Your paycheck is based on other distributors who you brought into Herbalife," said Cameron Jolly, one of the two attorneys representing the distributors. "It focuses on what your purchase volume from Herbalife is or from people in your down line. It is purchase volume, not retail volume."

However, Herbalife states in court documents that supervisors must make sales at least 10 separate retail sales each month, and it performs monthly random audits of 100 supervisors to ensure they are complying with the rule.

Herbalife refused to make Johnson or any other executive available for an interview. However, company spokesman George Fischer sent an e-mail to the Business Journal disputing that the company is a pyramid scheme.

"We will be celebrating our 30th year in business next year. Our rules and training place the primary focus of our independent distributors on the promotion and sale of our products, and earnings may be achieved only through continuing sales of products for consumption," the e-mail stated.

The group of eight distributors left Herbalife in stages between 2006 and 2007.

Herbalife then filed suit in April 2007, claiming that the former distributors violated their contracts by using the names, contact information and income levels of Herbalife distributors to lure hundreds of them to Idaho Falls, Idaho-based Melaleuca, which also sells health and wellness products.

"What's really left here is that both sides are staring each other down with a gun pointed at each other's head," White said. "It's an all-or-nothing game for both sides."
