Usana

Analyzed

A case of

Corporate Identity Theft

An in-depth analysis of the business model,
recruiting tactics, retailing, pricing, profits,
growth, pyramiding, market saturation and collapse

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Usana Health Sciences: A Case of Corporate Identity Theft

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> *"It is difficult to conceive of a more deliberately fraudulent and maliciously dishonest pattern of doing business with the public. [The defendants] gorged themselves on their ill-gotten gains from highly credulous consumers. They engaged in practices in which duplicity was the keynote and fraud the keystone of a commercial enterprise designed to pillage the public. None has the right to earn his livelihood in this fashion."*
>
> – *New York Supreme Court in 1966 in the State v. ITM Inc. case (a pyramid scheme)*

I. Usana Investigated

On March 20, 2007 *The Wall Street Journal* reported that the United States Securities and Exchange Commission has begun an informal inquiry into Usana Health Sciences (NASDQ: USNA).[1] The inquiry was prompted by the release of a 500-page investigative report by Fraud Discovery Institute, co-founded by well known fraud investigator, Barry Minkow. The report charged and offered evidence and analysis that Usana's business model is untenable, that the company functions as a pyramid scheme and that Usana's SEC filings contain significant omissions and misrepresentations. Numerous class action lawsuits have since been filed against Usana based on these disclosures and the subsequent drop of more than 20% in the price of Usana stock. Chat rooms have since been ignited with fierce arguments about:

- whether Usana is an "endless chain" pyramid recruitment scheme;
- how many distributors are actually recruited into Usana each year, how many drop out, what their losses are and whether Usana deceives consumers and shareholders about the recruitment program;
- why Usana was not investigated by the FTC;
- the remarkably high prices of Usana vitamins and whether there is any significant base of retail customers;
- why Usana founder, Myron Wentz, abandoned his American citizenship and established legal residency in a Caribbean tax haven and then placed the largest ownership share of the company in a European tax haven.

The battle rages on YouTube.com and in Yahoo financial blogs. Usana has attacked the motives and credibility of the co-founder of Fraud Discovery Institute, Barry Minkow and sued him for defamation.

To explain the widespread financial losses and extreme dropout rates among the distributors, which Fraud Discovery Institute uncovered, Usana downplays its income plan and claims that thousands of people join its sales force only to get the products at a discount, not to earn a profit. Usana seeks to define the fraud charges as technical issues concerning buyer motives, competitive pricing, and milligrams of vitamins – hardly matters that should worry the SEC.

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[1] "SEC Probe Into Usana Is Under Way" by Keith J. Winstein, *The Wall Street Journal*, March 20, 2007; Page C7

A. "Fully Disclosed"

Despite the findings and charges in *The Wall Street Journal*,[2] the deception of Usana could indeed be overlooked by the SEC, as it has been thus far, not because the issues are minor or technical but because the deception is so extreme and pervasive. Some have called Usana' inherent deceptions "fully disclosed." Yet the picture that Usana presents openly and fully is only a phantom and a mirror trick. The real Usana is revealed only when the protective covering of a false identity is removed.

Unlike frauds that are distortions and abuses of legitimate business, Usana's deception is fundamental. The distinction is analogous to one who cheats at poker, a legitimate card game, and another who runs a Three Card Monte game, a classic scam involving cards. No one cheats at Three Card Monte. The game itself is the swindle. Traditional frauds involve crooked transactions that are hidden inside an otherwise legitimate model. Usana turns this model inside out by conducting legitimate operations, such as making useful (though absurdly overpriced) products, inside the flawed business model of a pyramid recruitment scheme. Because of the multitude of seemingly innocuous or even positive aspects of the scheme – making products, paying employees, dispensing commissions, giving money to charity, paying taxes, and sending timely reports to the SEC – the fundamental, structural and inherent deception that is carried out can go undetected.

Usana's deception is larger than omissions in SEC filings, far more harmful that foisting overpriced products, more far reaching than lavishing stock options on its insiders, more significant than tax avoidance by its top executive, and much more serious than fake resumes of its directors, conflicts of interests by its medical advisors and gross misrepresentations to its distributors, though all of this occurs. The deception is even grander in scale than operating a product-based pyramid scheme.

Usana's real deception should be properly classified as *corporate identity theft*.

B. Corporate Identity Theft Defined

Corporate identity theft differs from the personalized version in that the perpetrator company does not assume another honest company's identity but rather takes on the identity of a non-existent, mythical business. It then presents itself publicly with all the assumed qualities, assets and operations of the false identity. Far from hiding in the shadows like individual identity thieves, the perpetrator of corporate identity theft operates openly, safe within its splendid disguise.

In Usana's case, the company falsely identifies itself as a "direct selling" business that sells "through" a network of "entrepreneurs". It claims these entrepreneurs resell Usana products and earn profits from retailing. Usana characterizes the distributors as a "channel" that is able to sell

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[2] A March 15, 2007 article in *The Wall Street Journal* reported that only 37% of Usana's associates had ever earned a commission, and among those who had been paid, 87% didn't earn enough to cover the $116 they have to purchase or refer each month to qualify for commissions; Usana's chairman, Myron Wentz, renounced his U.S. citizenship and now claims citizenship in the Caribbean tax haven of St. Kitts and Nevis; Wentz controls a 45% stake in Usana held by a company in the Isle of Man, in the Irish Sea, which in turn, is controlled by an entity registered in Liechtenstein; Usana's price for its vitamins is more than 20 times that of mass-market brands like Wyeth's Centrum; and that applying a formula used by the FTC to test the legality of multi-level marketing companies to Usana, the company would escape classification as a pyramid scheme if at least 63% of its sales were "retail"; only 14% of Usana's revenue comes from sales to customers unaffiliated with the company.

Usana's virtually unknown brand at prices that are extraordinarily higher than others in the same market. These distributors, Usana says, are able to compete effectively against internet outlets, Wal-Mart, grocery stores and health food stores because of their superior training and knowledge of the products. They do this, Usana claims, without need of national advertising. They can even make these sales without ever having to offer discounts, thereby providing very high and remarkably stable profit margins to Usana. These margins are so stable and resistant to downward pricing pressure, which characterizes the rest of the vitamin and food supplement market, that Usana does not even care which of the products the channel sells. The company gets the same high margin across the entire product line.[3]

As will be explained in more detail, none of this is true. The company that Usana pretends to be in its SEC filings and in its promotions to the media and financial community does not exist. This mythical enterprise perhaps existed in the distant past. It seems to resemble the Fuller Brush Company or Encyclopedia Britannica company of decades past. It seems to have elements of Avon in past years or Mary Kay.

It should be noted that this device of assuming a false identity is pervasive in the "multi-level marketing" field, which Usana is part of. Even the trade association of this industry, the Washington DC-based Direct Selling Association (DSA), engages in identity theft.[4]

Though some competitor companies are harmed by a corporate identity thief's deceptive trade practices, the main injured parties are the thousands or millions of people who make investments, purchases or who commit labor and time based on the phony identity. Some may risk – and lose – their entire fortunes and livelihoods to the company based on its deceptive claims and promises.

C. The Real Usana

- Usana's "channel" is actually a constantly churned group of consumers who are lured into investing as Usana distributors with misleading promotions about an "income opportunity." They are not making sales to consumers. They are not better educated about nutrition. For the most part, they have no customers. The distributors themselves are Usana's "end-users."
- The income opportunity offered by Usana is the classic endless chain trick, holding out the potential of money transferred from multiple, connected levels of recruits, each level recruiting a larger group below and a percentage of money from all the ensuing purchases going to the recruiters above, a form of chain letter.

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[3] This "direct selling" narrative with the description of the "channel of entrepreneurs" who never have to offer discounts was delivered by Usana CFO, Gil Fuller in an August, 2004 interview on CNN's "*Money Gang*" show and is available on YouTube.com. Versions of the narrative are repeated at financial analyst meetings. See the full transcript of the CNN show at http://www.accessmylibrary.com/comsite5/bin/pdinventory.pl?pdlanding=1&referid=2930&purchase_type=ITM&item_id=0286-4352604. The video is at http://www.youtube.com/watch?v=cT66if2CSkg

[4] In April 2003, approximately two and a half years after the non-profit organization, Pyramid Scheme Alert, had launched its independent website, http://www.pyramidschemealert.org/ and gained worldwide recognition for its name – receiving tens of thousands of visitors monthly and being frequently referenced in the media – DSA purchased the exact name of the Pyramid Scheme Alert site but with .com and .net endings. These bogus names were then advertised on the web by DSA. Consumers who mistakenly went to these addresses were linked back to the DSA's own site. In October, 2006, DSA repeated this trickery by purchasing the namesakes of another widely read consumer education site, http://www.mlm-thetruth.com/, which is published by a Pyramid Scheme Alert Advisor, Dr. Jon Taylor. Both ruses were carried out by DSA Communications Director, Amy Robinson.

- 40% of the wholesale price of Usana products is transferred from the new recruits to earlier ones. 70% of all payments goes to the top 3% of the sales chain, which, along with other factors, causes nearly all others to lose money.
- Usana only offers a 25% gross profit on retail sales.[5] The products are also exorbitantly priced compared to similar products. With the small retail profit margin, high prices and high cost of selling an unknown brand, retail selling is implausible. Distributors soon discover that without the attachment of the bogus income opportunity to Usana products, there is no market for its brand, which is virtually unknown. *The distributors buy the goods but do not resell them.*
- Rather than retail the products, the ill-fated distributors are directed to recoup their own costs and gain a profit by recruiting other distributors just like themselves. No concern is given to market saturation. Since the "endless chain income opportunity is presented as "unlimited" so is the market.
- To access this supposedly lucrative income opportunity, the recruits are urged to make a large upfront investment of money by purchasing a mythical entity called a "business center". The business center is not a physical location, has no equity value and the purchase does not convey any new rights other than a higher portion of money gained from new recruits. All recruits are urged to buy three "Business Centers" and are told they will double their commission rate if they do so. The value of the business center is totally based upon future recruiting by the purchaser, and, more importantly, upon the recruitment work of others in the "downline."
- Virtually no consumer in the world ever pays the retail price for Usana products. The one group of customers that Usana publicizes who are not also part of the "channel" buys Usana goods at *distributor* pricing. And there is only one of these customers for every two distributors.[6] Most of Usana's "sales" are gained directly and ultimately from its distributors who are persuaded to purchase a set quota of products under a monthly "auto-order" program with a pre-approved credit card charge. The quota qualifies them for the future payments based on their recruiting other distributors.
- As would be expected in a pyramid recruitment model, the great majority of all its distributors must always be positioned at the bottom where no profit is possible. Without a profitable retail selling option, most distributors face mounting costs and no profit. In less than a year, 50-70% quit the scheme. Usana's business model is therefore based upon the

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[5] Data from Official Usana US Price List (July – Sept. 2006)

[6] The "Preferred Customers" are notably publicized by Usana but sparsely described. They can buy Usana products at the same prices available to distributors. 87% of all Preferred Customers are in the US and Canada, which has only 54% of the distributors and 61% of sales. On average they purchase $56 a month per capita of Usana products. This figure is based on Usana's disclosure of "active" Preferred Customers, only those that made a purchase in the previous three months. The total annual purchases, on the other hand, which Usana claims account for 14% of its total revenue, consist of all purchases by all that were enrolled during the entire year. The actual per capital average annual purchase may, therefore, be much lower. Their small number in relation to distributors (one Preferred Customer for every two Distributors) raises many questions. Usana does not provide any demographics about these customers or their retention rate. In other MLM companies, participants have reported creating surrogate customers in order to meet purchase quotas. In other cases, the customers turn out to be close family members of the distributors, buying only to "support" the distributor's new business venture and who stop buying the products as soon as the distributor quits the scheme. (50%-70% of the MLM distributors quit within a year).

relentless replacement of the doomed-by-design distributors. Another part of the program is to convince distributors, as they join and throughout their short tenure, that failure will only be due to their own lack of talent, ambition or effort or to a lack of faith in and adherence to the Usana marketing program.

II. The Enron Analogy

To put the false identity strategy of Usana in proper perspective, an analogy involving a better known company that also employed a false identity will be useful – the rise and fall of Enron.

Claiming a unique ability to generate profits and growth, unmatched by other companies that labored in conventional models, the Enron Corporation lured hundreds of thousands of investors, contractors and employees into ultimate financial ruin. Enron claimed to be global trading company akin to a stock or commodity brokerage with extraordinary foresight. Other companies struggled in the present. Enron always seemed to be in the future. While others engaged in mere brokering, Enron was "making" markets.

At other times Enron portrayed itself as a conventional energy-producing company like a Blue Chip utility. It combined the best of the brick-and-mortar business world, selling energy, a product with ever-growing demand, and the alacrity and flexibility of a trading firm dealing in futures, abstractions, and derivatives. It had a multitude of subsidiaries and yet a tightly woven structure and focused identity. It was the company of the future. Enron said it has perfected an entirely new business model.

As was later revealed, Enron's fraud involved false or misguided accounting, misleading publicity, falsely reported sales, phony subsidiaries, compromised and corrupted analysts, manipulated stock prices, and SEC reports that omitted or misrepresented material fact. But its most spectacular and successful fraud was its portrayal of a new business model that operated under a different set of economic laws and principles.

The Enron model did not exist in reality, but most of the world believed Enron's promotions. Assuming the identity of an economic miracle, Enron grew to be America's 7th largest corporation. Its executives sat at the right hand of the President Bush and were leading participants in the Vice-President Cheney's famously secret energy policy meetings. It lavished contributions on politicians and donations upon charities, thereby gaining allies, promoters and supporters and as well as acquiring protection from prying eyes of regulators. Its executives were lionized in the nation's most respectable business magazines.

The false identity enabled Enron's stock sales to operate as a contrived pyramid scheme. Fictional promotions, accounting trickery and the mirage of unlimited growth drove up the stock's price. The advancing stock attracted more shareholders. The demands of more shareholders drove up the price further and repeated the cycle.

When financial collapse occurred the Enron business was suddenly and widely recognized as an outrageous and blatant scam. The company's profits were seen to be the old trick of robbing Peter to pay Paul.

Yet, during its heyday, the preposterous claims and manipulations were duly reported in the media as valid and factual. The company was never seriously investigated by federal regulators. Financial analysts almost universally advised the public to buy the stock and to trust and emulate the company's executives. The larger Enron grew and the longer it endured in its false identity, the larger the scale of harm it ultimately caused.

Enron's fraud was not a matter a corruption of an otherwise legitimate business. The fraud was inherent, pervasive and fundamental. The scam was based on the false identity, the bogus business model, and the claims of its uniqueness. Its chairman, Ken Lay who later was convicted of fraud but died before serving his sentence, served as the company's prophet and evangelist. These priestly roles served the company well since Enron's real product was faith, not energy. In the end, it was a confidence scheme.

III. Uncovering Usana's True Identity

A. False Identity: *Direct Selling*

Usana informs the SEC – and all the world – in its 2006 10K,

> "We distribute products through a network marketing system, which is a form of person-to-person direct selling through a network of vertically organized independent distributors who purchase products at wholesale prices from the manufacturer and then make retail sales to consumers… We also sell our products directly to "Preferred Customers" who purchase our products for personal use and are not permitted to resell or distribute the products… As of December 30, 2006, we had 153,000 active Associates and 78,000 active Preferred Customers worldwide, which accounted for 86% and 14% of net sales, respectively, during fiscal year 2006… We feel that network marketing appeals to a broad cross-section of people, particularly those seeking to supplement their income, start a home-based business, or pursue entrepreneurial opportunities other than conventional full-time employment."

The picture is clear. 153,000 "entrepreneurs" and others seeking to supplement their income or operate a home-based business "purchase [Usana] products at wholesale prices from the manufacturer [Usana] and then make retail sales to consumers."

Usana Health Sciences is a member of the Washington, DC-based "Direct Selling" Association, which is mostly composed of multi-level marketing companies like Usana. The DSA confirms this manufacturer-to-wholesaler-to-retail customer business model. To the question, "What is Direct Selling?" the DSA website explains,

> "Direct Selling is the sale of a consumer product or service, person-to-person, away from a fixed retail location. These products and services are marketed to customers by independent salespeople… Products are sold primarily through in-home product demonstrations, parties and one-on-one selling."[7]

Actual Operation: *Endless Chain Recruiting*

A few data points reveal the reality of Usana as a recruiting scheme not a retailing system.

1. Usana Has Virtually No Customers. It Sales Force Does Not "Retail" Its Products

- Usana reported to the SEC that at the end of 2006 that annual average purchases of Usana inventory by its USA distributors was just $2,100[8]. Usana offers the distributors a 25% retail

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[7] http://www.dsa.org/aboutselling/what/

[8] Usana reported $159,377,000 in wholesale sales in the United States in 2006 in its 2006 10K report to the SEC. 86% are made to distributors, equating to $321.8 million. Usana reported 153,000 "active" distributors. The total sales reflect all purchases by distributors during the entire year. The reported number of "active distributors reflects

profits based on suggest retail price. On this average purchase level, the most that the distributors could earn at 25% gross profit is, therefore, just $700 for the year or $13 a week. This is the average available *only* if they are able to sell everything they buy, use no products themselves, give away no samples and never offer one penny in discount! And this maximum average of $13 a week is *before* all other business expenses are deducted.

- At 59,000 distributors in the United States, each distributor would have a maximum market potential of just 1,900 households in all of America.[9] That market includes the poorest of the poor, as well as people that never buy vitamins and all those who would have no interest in Usana's high cost products and others that are already loyal to other brands. What percentage of these available 1,900 households could each Usana distributor ever expect to gain as loyal customers? What would it cost to find and win these customers? When would the size of the Usana sale force officially reach saturation?

2. More Money Paid to Recruiters than Retailers Can Earn:

- While on average the most that Usana USA distributors can earn from retail selling is far less than $13 a week, *which, after costs, would represent a net loss*, Usana paid more than this in total dollars to a relatively tiny number of promoters at the top of its pyramid chain. These payments are based on recruiting a "downline" of more salespeople, not retail selling.
- Usana transferred 40% of all the money it received from the distributors' purchases to the "upline" of recruiters, and 70% of that money went to the top 3%.[10]
- Far more money is to be made from recruiting salespeople (distributors) than the distributors could ever make retailing the product and the vast majority of all the money goes only to those few at the top.

3. There Is No Retail Sales Potential

- Usana does not even report how much of the goods are ever retailed by the distributors at retail pricing and keeps no data on the characteristics of retail paying "end-users."
- Usana products are priced much higher than nearly all competitors.
- Usana's brand name is mostly unknown and the company engages in no support advertising.
- The gross profit Usana offers for retail sales is half what conventional direct selling would require of 50% (buy for $100 and sell for $200. $100 gross profit on a $200 sale is a 50% gross profit.) Additionally, the constant enrollment of more and more resellers dilutes and damages the retail sales opportunity for existing ones.

4. The Model Is an Endless Chain, Top-Loaded, Pay-to-Play Recruiting Scheme:

- Each and every Usana distributor can recruit others and is rewarded when they do. The Binary Compensation Plan requires that each distributor recruit two other distributors in

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only those who made a purchase in the previous three months. Tot total number that made purchases during the entire year would be much higher and the actual per capita average purchase would actually, therefore, be even lower than $2,100.

[9] In the year 2005, there were approximately 113,146,000 households in the United States (http://en.wikipedia.org/wiki/Household_income_in_the_United_States)

[10] http://www.usana.com/media/File/Policies and Procedures page/US/US AveIncome.pdf

order to profitably participate in the plan. *If this chain were continued just 26 levels, it would exceed the number of all households in the USA!*

- To gain payments tied to recruiting, each Usana distributor must personally purchase a quota of Usana goods each month, approximately $116 every month, according to *The Wall Street Journal*.
- The majority of all Usana "sales" are made only to its own distributors who purchase the required monthly quota to "qualify" for payments based on purchases of other recruits.
- The higher the distributors move up the Usana sales pyramid the more they earn *per each purchase made by those at the bottom.*
- Of all the rewards transferred to the distributors based on purchases made by other distributors, 70% of the money goes to the top 3%.

B. False Identity: *"Excellent Channel"*

In an August, 2004 interview on CNN's "*Money Gang*" show, Usana's CFO, Gil Fuller told Fred Katayama, the stocks editor – and all the world – about Usana's "excellent channel" and its "big advantage."[11] According to Usana, the secret to the company's success is how its products are sold, the *CNN Money Gang* told viewers. They reported that Usana had "160,000 entrepreneurs" selling the products. Katayama asked Usana's CFO how did Usana differentiate itself from the huge market of so many other makers of vitamins and food supplements. Fuller stressed the value of its "excellent channel" that is product-educated. "Do they have nutrition degrees?" Fuller was asked. He explained that they do receive excellent and up-to-date information from the company that helps them sell the products. This sales model, he said, is better than in stores where there are thousands of products to choose from and the customer gets little information.

One member of the gang expressed some doubt about the viability of a vitamin company when are so many others in the same market. She was reassured when told about the "secret" of the "excellent channel" of "entrepreneurs." Strangely, no one in the *CNN Money Gang* asked, "Who do the entrepreneurs sell the product to?" And, though these entrepreneurs were said to be Usana's secret to growth and profits, no one asked how much money the entrepreneurs earned or about retention or drop out rates among the entrepreneurs or how the company recruited them.

Mr. Fuller left a clear impression of a large sales force of knowledgeable, savvy and ambitious people who very successfully competed with retail stores for customers. The customers, he explained, preferred buying from these entrepreneurs because they could get better advice and information.

Actual Operation: *The Channel is the End-User*

1. Not More Knowledgeable

- In fact, a typical Usana distributors is not more knowledgeable than a retail sales clerk. Most sign up at emotional recruitment meetings in which the main subject of presentation is "Usana's Income Producing Business Plan" described on its website as "Revolutionizing how People Create Wealth." They get product information only from Usana, not from

[11] http://www.youtube.com/watch?v=cT66if2CSkg The full transcript of the show can be read at http://www.accessmylibrary.com/comsite5/bin/pdinventory.pl?pdlanding=1&referid=2930&purchase_type=ITM&item_id=0286-4352604

independent sources. They do not even have access to information from other companies. Usana "independent" distributors are not allowed to represent other brands or any related products.

- Between 50-70% of all Usana distributors quit Usana – and stop buying the products – within one year, hardly time enough to become knowledgeable. No training or education is required to become a Usana distributor. There is no training period and no formal training program. A Usana distributor can solicit customers the day after signing the contract.

2. Not Entrepreneurial

- A sales force in which nearly 70% quit within a year might be characterized as transient, unstable or incompetent before the term "entrepreneurial" would be thought of.
- A channel in which 97% earn less than $4 a week in commissions from the company, *before product purchases, taxes and all other business expenses* might be characterized as failed, misled, untrained, victimized, or even foolish, before the term "entrepreneurial would be thought of.[12]

3. Not a Channel

- A channel that has no retail customers cannot be called a channel. A channel to whom? To what? Only 14% of all "direct selling" revenue of Usana comes from consumers who are not also Distributors. These are called "Preferred Customers." All the rest of the money comes from the purchases of the distributors themselves, a fast turning, revolving group. There is only one of these Preferred Customers for every two distributors! Hardly a retail customer base. And to get that small amount of retail business, the channel had to sell at their own cost, earning no retail profit at all. Preferred Customers buy at the distributor price, wholesale.
- Mr. Gil Fuller, the Usana CFO interviewed by the CNN *Money Gang*, must have known that Usana does not have a channel. What he described and characterized as a channel is in fact Usana's end-users. Usana has virtually no other customers. The distributors do not resell the products at retail prices and do not purchase enough inventory on average to support a net profit.
- The so called entrepreneurs are indeed seeking to "supplement their income" and operate a "home based business" just as Usana reports in its SEC filing. However, Usana neglected to report to the SEC that on average almost none achieves a profit and the vast majority fail and quit within a year – and stop purchasing the products – and almost none ever retails any products at all.
- The entrepreneurial opportunity that Usana offers them – that Usana says is "revolutionizing how people create wealth" – is not to operate as a sales channel that competes with health food stores and Wal-Mart, but rather to expand their own ranks through endless chain recruiting. Since such an endless chain expansion program is a mathematical mirage that could only profit a tiny few at the top, this could not even be called an "opportunity", but

[12] An analysis of Usana's payout data shows that only 33.77% of the North America received any commission and the mean average payments received by the bottom 97% of all distributors is $3.43 per week. 70% of all payments are transferred to the top 3% of distributors.
See http://www.usana.com/media/File/Policies%20and%20Procedures%20page/US/US%20AveIncome.pdf

rather a cruel trick, a money trap, a deceptive trade practice. This is just another version of Enron's scheme of robbing Peter to pay Paul. At Usana, a few hundred Peter and Pauls at the top of the scheme rob thousands of other Peter and Pauls at the bottom. Usana pays them to do this and calls it "sales."

C. False Identity: *Hot NASDAQ Stock, Fast Growing Company, Profitable, A "Buy"*

The financial community has not examined the Usana business model, the source of its revenue, its actual customer base, or questioned how a virtually unknown vitamin brand with no national advertising and that arguably has the vitamin industry's highest prices in a very crowded, commoditized field could be skyrocketing in growth. Some have credulously accepted Usana's self-proclaimed identity of a "direct selling" company with an "excellent channel" of "entrepreneurs" who sell the product based on their superior product knowledge as the "secret" to its growth.

The flash of profit reports, revenue growth and rising stock price blinded the analysts who were already misled by Usana's diversions and false identity maneuvers. On the 2004 *CNN* show where the *Money Gang* selected Usana as its "stock of the day", Fred Katayama introduced the company,

> "Usana Health Sciences, one of the fastest growing firms on the NASDAQ. It grew nearly 40 percent a year between 1995 and 2000. Its stock is growing just as fast as the company … The small firm is based in Salt Lake City. It directly markets vitamins, nutrition bars, shampoos, tooth paste and other health and personal care products. In the last 12 months it earned nearly $27 million on sales of more than $240 million… Sporting a net profit margin of about 11 percent."

The view within the financial community of Usana of a solid, growing and profitable company and a good stock to buy reflects an ignorance about multi-level marketing and an unquestioning acceptance of Usana's false identity as a mythical "direct selling" company.

As part of my investigation for Fraud Discovery Institute I examined the stock analysts reports on Usana including *Pechala's Reports No. 11/27/06, Value Engine 11/27/06, Market Edge Research Nov. 27, 2006, Ford Equity Research, Data as of Nov. 24, 2006, Wright Investors' Service, 11/24/06, Price Target Research, Nov. 27, 2006, Economic Investor, The Economy Matters, Nov. 28, 2006* and *Standard & Poors as of Nov. 24, 2006.*

None of these reports reflected, discussed or analyzed the basic multi-level marketing model. None reflected, discussed or analyzed the most important factor affecting Usana's future growth – the ability of the company to significantly increase the size of its independent sales organization. None of the reports discussed the related factors of average income of the distributors, dropout rates or the ability of the sales force to resell Usana goods at a profit. And, none of the reports reflected, discussed or analyzed the ultimate end-users of Usana's products, though Usana's business was routinely described as "direct selling" and as a company that sells "through" a network of independent distributors.

Actual Operation: ***Churning, Saturation, Fixed Prices, Imminent Collapse, Predatory Recruiting***

1. Red Flags

Rapid growth of an unknown brand with no advertising and very high prices ought to be a red flag of caution for analysts, not a green light for endorsement. One other multi-level marketing company followed this same pattern of explosive growth, even making it to the #1 position on *Inc Magazine's* prestigious list of "500 Fastest Growing Privately Held Companies" in 1996 It was subsequently shut down in 2000 by the FTC as an illegal pyramid recruitment scam.

The company was Equinox International. Equinox also sold vitamins, skin care products and food supplements and it was also a member in good standing of the Direct Selling Association.[13]

Inc Magazine, like the *CNN Money Gang,* never inquired how the company could achieve this growth or who its real customers were. It turned out that virtually the only people buying Equinox vitamins were Equinox distributors. They sought to recoup their investments and make a profit buy recruiting other distributors. Under the Equinox pay plan, like Usana's, they made money from a chain of new recruits' purchases.

Not in the transcript but on the video of the *Money Gang* Show one of the panelists did express doubt about how one vitamin company could grow rapidly in such a crowded and commoditized market. The question was dismissed with talk about the "secret" of selling through network marketing's channel of entrepreneurs (not realizing that there are scores of other network marketing companies, using similar pyramid pay plans and also selling vitamins and food supplements and most of them have also shown this strange pattern of rapid growth.)

To put the kind of extraordinary growth exemplified by Usana into proper perspective, one might need to understand that *all* pyramid schemes grow *explosively*. They have an electrifying incentive that can motivate people to join quickly and avidly enroll others. *That incentive is the potential of endless-chain income* from a huge group of self-generating memberships, a large part of whose payments would flow directly to the recruiters at the top of the chain.

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[13] In April 2000, the FTC and eight states successfully prosecuted Equinox International. The FTC Complaint for Permanent Injunction stated that "the Equinox program is an inherently unlawful scheme whose essential element is the payment by participants of money to the company in return for which they receive (1) the right to sell a product, and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to the sale of the product to the ultimate users…. The result of the structure and operation of the program is that financial gains to Equinox participants are primarily dependent upon the continued, successive recruitment of other participants… This type of scheme is often referred to as a pyramid."
The settlement resulted in shutting down the company, the payment in restitution of about $40 million to victims, and the banning of the company founder from the MLM business forever.
Equinox had been in business – operating in the same manner that caused it to be shut down in 2000 – since 1991. As many as 300,000 Americans joined Equinox as "independent distributors" during its nine-year tenure. The FTC complaint stated, "The vast majority of Equinox distributors discontinue their participation in the Equinox program with little or no financial success… A very small percentage of distributors who become participants in the Equinox program actually make more money than they expend." Yet, despite the enormous losses among the vast majority of sales reps, Equinox revenues grew from $545,000 to $195 million between 1990 and 1995.
INC Magazine listed Equinox #1 in its 1996 "Inc 500" list of the fastest growing privately held companies. The edition that listed Equinox as #1 also featured Equinox' founder Bill Gouldd on the cover and included a positive interview with him. One of the other companies *INC* referenced as an example of the Equinox business model was Jewelway. Jewelway was also subsequently prosecuted by the FTC as an illegal pyramid scheme.
Equinox was a dues-paying member of the Direct Selling Association (DSA), the official trade group of the multi-level marketing industry.

The need for an income opportunity is, arguably, the greatest need today among consumers in America. Out-sourcing, overcapacity, new technologies and increased productivity threaten all consumers' economic positions while debts rise, costs of living increase, and wages stagnate. To offset these trends, many people are working two or even three jobs.

Usana has a perfectly polished sales pitch for consumers in search of some way to add to their incomes. Buy a ticket to the Usana pay plan, buy $120 a month of Usana vitamins and start recruiting. The money will come rolling in later and recoup all your costs. Over time, it can "create wealth."

In the mania of testimonials about wealth and leisure and excited hope that is falsely raised at the Usana recruitment meetings, few people will realize that only a tiny few can ever be at the top of a recruitment chain. Some who might notice this mathematical reality can convince themselves that they will be among the chosen few. Others are seduced by garish images of the opulent lifestyles of Usana's top recruiters and the promoters' claims that "anyone can do it."

The electrifying incentive employed by Usana and other MLM companies is deceptive, unfair and misleading, but when it is attached to a product that product will gain many purchasers and few will question the price. Indeed, a product attached to this magical income machine can take on nearly miraculous properties, just like Usana's. *It is the electrifying and false income promise that drives Usana's growth, not its "educated channel."*

2. Not True Profits

All pyramids *appear* to show strong profit. In the pyramid model, what is called profit is actually a percentage gained from orchestrating a system of transferring the investments of later recruits back to earlier ones. This is not sustainable and therefore should not be listed as profits on a P&L sheet. The latest purchases, which always constitute the majority of annual revenue are *liabilities*. No sales achieved in this manner are final and therefore money gained from these sales are not net profits.

When the FTC prosecuted Equinox International for running a similar money transfer scheme by selling only to distributors, much of Equinox' "profit" was "disgorged" back to the victims in the FTC settlement.

3. Not True Sales

What Usana calls "sales" – purchases by distributors – are predicated on the distributors' future actions to recruit other distributors and, even more importantly, a chain of those other distributors continuing the recruitment process. Those future purchases are presented as a means to discount the earlier recruits' costs or to provide a profit. Each "sale" is based on this promise (liability) of a future action of recruitment. The vast majority of Usana's annual revenue comes from the purchases of the newest recruits and the real value of all of those purchases is contingent on their future recruiting.

Usana's system of calling purchases by distributors "sales" is analogous to loading a distribution channel with inventory and declaring the transfer to be "sales." This is a classic maneuver and accounting device to give the false illusion of a strong spike in sales or to cover up a slump. In fact, they are not true sales until the distribution channel resells the inventory to end users.

Usana's business model is *permanently and continuously* based upon loading the channel with high cost products, marked up 66% (each distributor's purchase includes this markup that is transferred to the upline of recruiters). The distributors are told they can either retail the products in order to recoup their costs and make a profit, *which nearly all will not be able to do*, or recruit other distributors in order to recoup their costs and make a profit, *which nearly all will also not be able to do*. Traditional companies could only engage in inventory loading once in a while, if at all. Loading the channel is an abuse of the distributors as well as deceptive to investors who are misled by the accounting maneuver. The unsold inventory will only lead to lower levels of distributor purchases later.

Usana, however, is able to maintain the trick by continuously *replacing* the distributors, which have unsold inventory and no ability to pass on their costs to new distributors. These "failed" distributors quit the scheme in droves. The mission of Usana is to constantly replace them.

Like the conventional company that loaded the channel only to either lose the loyalty of the distributors or to trigger even lower true sales in the near future, Usana faces its own reckoning. Eventually it will be unable to replace the ranks of consumers that it burns through every year. It must therefore always expand to new areas.

4. Not True Growth

Growth in the pyramid model is similarly an illusion. Nothing of substance is being developed. No loyal, sustainable customer base is being built. Indeed, the bigger challenge of the company is to keep all the past distributors – who lost money, quit the scheme and stopped buying the products – to remain silent and not speak about the company. This is achieved primarily by convincing them that their losses were their own fault. They failed due to lack of ambitions, effort, or they just had a loser's mentality, they are told. There is no one to blame but themselves. In addition to the pain of financial loss and dashed hopes, Usana adds the gag of shame. This works on most people and subverts the normal mechanism of the marketplace to drive out frauds and lemons through word of mouth warnings.

Usana's churning of failed distributors is more akin to strip mining than business growth. Real growth is organic or is achieved by acquisition. New business is based upon earlier work. Those who created the growth share in the larger success. In Usana, the great majority of all who generate each year's revenue – the newest recruits – are gone by the end of the next year. With no sustainable customers and no sustainable sales force, the company is in a race against time.

5. No Stability

What may appear on Usana's 10K report to the SEC as a picture of a strong and profitable business is in fact a company that is always just a few months from bankruptcy. If the recruitment machine falters even for one month, the spigot of money to the top is cut off immediately. And each geographic market is always depleting, since Usana is not building a sustainable customer base. When momentum slows, the top recruiters will quickly look for a new opportunity where they can "get in early." New territory is always needed and the available market is always shrinking.

Besides being in a constant, frenzied state to replace its ever-depleting sales force, which also serves as its customer base, the company must work hard to keep a lid of the hard facts about distributor losses, churn rates and concentration of payments to the top levels. And finally, the company must also engage in a diligent effort to stave off federal or state anti-pyramid regulations or the transparency[14] that could trigger lawsuits. Proper regulation would cause immediate collapse. Lawsuits could open a window to the pyramid reality.

6. Not Market Priced, but Price Fixed

In the *CNN Money Gang* interview of 2004, Usana's CFO Gil Fuller stated,

> "We're nearly indifferent as to which of our products are selling. I think one of the excellent things about using this channel is that you have a bit more control over your gross margins. "That is, the pricing decision is more squarely rested on us rather than, say, purchasing agents from the big box kind of stores, the typical retailer. So we have been able to do that. We're almost indifferent as to which of our products are selling because of the margin management that we're able to exercise over it."

The price decision rests with Usana and not the customers? How could Usana be "indifferent" as to which products it sells? Apart from controlling its own costs, how could Usana exercise "margin management"? Usana is claiming it controls what the market pays! Normally, this is a sign of price fixing or bogus sales transactions, as Enron conducted.

Unwittingly, Mr. Fuller revealed, for just a moment, the real Usana, in contrast to the false identity of the "direct selling" Usana. The real Usana does indeed have the means to fix prices.

The real Usana, effectively, has one channel and one end-user base, *which are one and the same*. All other competitors have various channels that sell to the wide open consumer market or they may sell directly to consumers. In all such cases, they compete on price and quality. They contend with distributors and customers who pressure them to lower prices. This is the way the free market works.

But at Usana, the end-users are also the distributors and the distributors' behavior, selling activities and pricing are rigidly controlled under legally binding contracts that define them as "independent contractors", not consumers. They incur special responsibilities and severe restrictions on their marketplace freedom including whom they can sell to and buy from.[15] The

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[14] Usana has vigorously opposed the recent "business opportunity" rule proposed by the Federal Trade Commission that would require Usana and companies like it to disclose more information to recruits. In a letter to the FTC, Usana president, Dave Wentz, wrote, "On behalf of USANA Health Sciences, Inc. ("USANA"), our employees and our more than one hundred thousand independent distributors, I am writing this letter to express our concerns about the proposed New Business Opportunity Rule (R511993). We believe the Rule as presently drafted could hinder or even ruin USANA's business…" See http://www.ftc.gov/os/comments/businessopprule/522418-05323.pdf

[15] Among the extraordinary restrictions placed on Usana distributors, whom Usana tries to claim are actually end-user customers:

- Associates cannot disparage Usana products, the compensation plan or Usana employees. They also cannot disparage other Associates (If the Associates are, in fact, distributors, then these "other Associates" whom they cannot disparage, are their competitors for retail selling), (Policies and Procedures 4.2, Page 7.)
- Associates cannot change their line of Sponsors (the people who get commissions from their purchases, i.e, effectively, are their vendors.) (Policies and Procedures 3.22.1, Page 6.)
- Associates cannot solicit other Usana Associates or Preferred Customers to invest in any other multi-level marketing business, whether or not it sells products similar to Usana's. (Policies and Procedures 3.6, Page 4.)
- Associates cannot offer any other products or services to customers in conjunction with sales of Usana products (Policies and Procedures 3.6, Page 4.)
- Associates cannot competitively solicit prospects for two weeks time that are brought to Usana events by other Associates. (Policies and Procedures 3.6, Page 4.)
- If Associates participate in other multi-level marketing programs, they are disqualified from Usana Leadership Bonus program. (Policies and Procedures 3.6, Page 4.)

prices are fixed within this system. Each member could, theoretically, resell their products at any price they wished to. However, the exorbitant price they purchased them for largely prevents this. So, the preponderance of sales transactions and the great majority of Usana's revenue consist of the sales only *within* this controlled group. The “upline” element of the membership (the ones who got in early) sell to (recruit) the “downline” group in strictly controlled genealogies.[16]

The top organizers of the genealogies (top Upliners) are akin to franchises. Usana forbids these franchise-like promoters from selling to one another’s customers (the Downliners). In this way, Usana prevents competitive pricing. *Usana even prevents competitive prospecting*! Once an Upliner identifies a downline prospect and brings them to a Usana recruitment meeting, another Upliner cannot approach that prospect for a specified time period for recruitment into his own genealogical line.

Each “franchise” (top level of each genealogy) buys at the same price from Usana and cannot offer discounts to their Downliners. All sales go through Usana and the price is fixed. There is no competition – based on price – within the private system.

The private network – what Mr. Fuller called an “excellent channel” – consists of consumers who join Usana’s private money-making scheme, the “Binary Compensation Plan” which Usana claims is “revolutionizing how people create wealth.” To join the income scheme, a consumer must buy a ticket, called a “Business Center”. The Business Center provides rights to recruit others into the plan. Payments are made to those who recruit the most and whose recruits also recruit the most. Buying three Business Centers increases the rate of company payments for recruiting other distributors. After buying the membership (Business Center), each member must then recruit two others (Binary) under each Business Center.

As is rather obvious, the plan closely resembles a *chain letter*. Each new member does not know where he/she is on the chain. The last one who joins is below hundreds of thousands of others, but is offered the chance to be at the top of a potentially huge chain of hundreds of thousands of others who join later. As in all chain letters, the “Binary Compensation Plan” pays the great majority of all the money to those at the top of the chain. Vast sums of money can potentially be gained from endless chain recruiting.

As in all chain letters, to gain the possible rewards one must not “break” the chain, that is, each person must bring in others. As those others do the same, the number of people expands geometrically (2,4,8,16, etc.) and the money flows upwards. Those who gain the most people below, make the most money, though everyone pays the same to join.

There are two key differences between Usana’s private money-making scheme and a traditional chain letter that one might receive in their email in-box. (though many receive solicitations to join Usana in their email in-box also.)

1. Membership in Usana’s chain letter requires *ongoing* payments. The purchase of the “Business Center” is only the down payment. To benefit, each member must *continue* to pay every month. Those who study the operation of pyramid schemes call this “pay to play.” In Usana’s case, the pay-to-play is ongoing, monthly at about $120 per month.

- Associates who leave Usana cannot solicit existing Usana Associates or Preferred Customer (who could be friends and family) to enroll in other direct selling program for a period of one year. (Policies and Procedures 3.6.1, Page 4.)

[16] See previous footnote for a fuller list of restrictions on Usana “customers.”

2. The second difference goes to the heart of Usana's corporate identity theft. The Usana chain letter uses vitamins as its currency! In this way, the business appears to be about vitamin sales, not the chain letter schemes. The payments involve purchases of Usana's products – pills, potions and lotions.

Here is where Usana's price fixing ability becomes crucial. While each player in the Usana chain letter must buy about $120 a month of Usana pills, potions and lotions, 40% of the price is applied to chain letter payments. Usana uses a complex formula for disbursing this money to the people in the upper levels of the chain letter, but in the end, over 70% of all the money winds up in the hands of the top 3%.[17] Usana's extraordinarily high prices can be maintained because no one is actually buying the pills based on price shopping and quality comparisons. They are buying them as part of an *income scheme*. Purchases constitute *membership dues* to participate in the Usana chain letter. The purchases serve a higher purpose – as a means to possibly get rich!

The Usana scheme can also be seen as a private lottery. As is often pointed out in Usana recruitment meetings, each person could benefit immensely from the luck of recruiting another hot recruiter. (The more you recruit, the greater the chances of finding this key person!) Just one hot Downliner could push you to upper positions where the larger numbers increase the odds of the downline self-generating without any effort on your part. You could hit the jackpot!

Within Usana's private channel/end-user group, members pay-to-play by purchasing the quota level of products monthly in order to participate in Usana's true business of expanding the channel in an endless chain. Usana *fixes* the price of those transactions and also controls who can sell to whom. The price is fixed and channel sales are strictly controlled to prevent competition within its controlled market. This market consists almost entirely of consumers who sign highly restrictive contracts *as resellers*, and are thereby regulated by Usana's strict channel pricing, *but they do not resell*. To complete the façade, they are even charged sales tax on their wholesale orders, based on the suggested retail price, though, few ever resell them![18]

The Usana price fixing and sales control reveal a closed system, *a pyramid scheme*. If Usana could not require its recruits (end-users) to pay these high prices, it would have to sell its products at market prices, which it would not be able to do. If Usana had to sell at market prices, it also could not markup its products 67% (40% of the sales price to distributors equates to a 67% markup by Usana) to pay the Upline. Its Upline would abandon the scheme quickly.

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[17] The concentration of the money at the top – in chain letter fashion – is actually even more severe. Approximately 1/10th of one percent or fewer than one per 1,000 of the "active" distributors (Usana substantially reduces the real number by only counting those that made purchases in the last three months) received 31% of all commissions. These 160 individuals are the people who operate the worldwide genealogies (akin to franchises). They are prevented from competing on price with one another, though virtually every other member "buys" from one of them. This tiny group receives largest the percentage of commission on all sales according to the "chain letter" pay plan.

[18] States benefit from this facade by collecting taxes on sales that never occur. In the USA, Usana sold $159 million of goods. 86% was purchased only by Distributors at $136 million. However, Usana collected and paid the states sales taxes from the distributors at the suggested retail price which is 33% higher, reflecting a maximum potential of 25% retail gross profit margin. So the distributors were required to pay taxes on $181 million, representing the mythical retail sales they were supposed to have made. This could amount to as much as $1.3 million in taxes paid by the distributors (figuring an average state tax of 6%) based on a false claim of $22 million in retail gross profit margin that they never received – because the retail sales never occurred!

Usana is not competing with Wal-Mart or health food stores for vitamin sales because vitamins are not Usana's actual product. Vitamins serve as the *currency*, not the commodity. The real commodity is the bogus income plan, the endless chain income stream. Usana distributors are given compelling financial incentives to recruit other resellers. But to get access to the potential income, each distributor must buy the vitamins, as does each new recruit. Every day, thousands pursue that futile quest until their losses grow unbearable and they quit. Most quit within one year – an stop buying Usana products – and are quickly replaced by new hopefuls who also buy at the same high prices. This is what Mr. Fuller calls "margin management."

7. No Customers and Not Driven by Products

Usana has no end-users of any financial consequence. It does gain 14% of its revenue from individuals who are not part of the pay-to-recruit plan. These might be called retail customers though they buy at distributor pricing. Many of these, however, may only be family members of distributors who agree to make purchases in order to assist their friend or relative in meeting the monthly purchase quota. (Preferred Customer purchases can be credited toward the distributor's monthly quota). Otherwise, the company is utterly dependent on luring new people to join as distributors, knowing that 90-99% cannot earn a profit.

Moreover, while the company makes and sells vitamins and touts them as nearly miraculous in curative power, the products do not drive the sales. The vast majority of Usana's sales begin and end with purchases made by distributors who sign contracts that authorize them to recruit other distributors and be paid based on their investments (purchases).

Perhaps the simplest evidence that products do not drive Usana sales is the lack on ongoing product purchases by past distributors. Most quit purchasing goods *totally and forever* once they leave the flawed pay plan.

The majority of the Usana sales are not only to the distributors, but they are gained under the "auto-ship" plan in which the distributors agree to let Usana ship the goods each month under a pre-approved charge to a credit card. *That monthly amount is the exact level needed to qualify for commission payments tied to recruiting*. The auto-ship program assures Usana of monthly orders, driven by a false income opportunity, and normally delays the date at which the distributor will inevitably quit the program.

The business of the Usana pyramid is to sell the pyramid. Though it may manufacture, ship and bill for products, its "salespeople" do not sell products. They recruit other salespeople. In so doing, they primarily sell the income opportunity available only to the "salespeople." The income opportunity to do what? *To sell the income opportunity!*

D. The Fatal Flaw

Beyond the risk of being prosecuted by the government and sued by consumers and investors for fraud, there is the most basic of all drawbacks to using the pyramid model and the endless chain "sales" incentive. The company that offers it cannot deliver on its promise. It is a lie. Almost none of the new recruits can actually get to the top. They must fail. Indeed it is their lost money that fuels the pyramid. They are the end-users, the proverbial bottom of the pyramid. As the inevitable failures realize their sad and doomed plight, they quit the scheme rather quickly, stop buying the Usana brand, and they must be replaced.

Compounding the problem of replacing the losers, the scheme must deal with the fact that the number of people who can be enticed and enrolled in any geographic area *is limited*. Market saturation looms and soon is reached, as in the United States with each distributor having less than 2,000 total households to sell to. The endless chain plan does not recognize market saturation. The recruiting continues unabated.

An endless chain scheme is not building a sustainable repeat customer base or a sustainable sales force. Its main product, after all, is not the commodity it delivers but the income opportunity that it *cannot deliver*. So, the company *must* continue to aggressively enroll. It has nothing else to offer. To do so, it must unconscionably promise the potential of wealth to all, while knowing its business model will, by design, always impoverish 90 to 99%.

The promoters know that the scheme is in a continuous state of collapse and, eventually, must find new territory where saturation will also be reached and the same predatory recruiting program will be operated.

Time and truth are its enemy in any market area. The scheme must keep moving.

