

**Expert Report on
Take Shape for Life, a Division
of Medifast, Inc. (NYSE: MED)**

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Submitted to: Fraud Discovery Institute

Re: Analysis of Business Models and Practices of
Medifast and *Take Shape for Life*; Potential
Violation of California's "Endless Chain" Statute;
Implications for Medifast Shareholders

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Update – February 16, 2009

In September, 2008, I submitted to Fraud Discovery Institute an analysis of the business model, marketing tactics, and distributor pay plan of Medifast Inc. (MED:NYSE). The report focused on *Take Shape for Life* (TSFL), a division of Medifast Inc. that utilizes the controversial “multi-level marketing” model.¹

This February update incorporates data from the 3rd quarter of 2008. It more closely compares Medifast to its competitors in the meal replacement field and the explanations Medifast has offered for its sudden rise in revenue and stock price, unique in the meal replacement industry during the economic Recession.

I examined implications of the *Take Shape for Life* for Medifast shareholders. In recent years, Medifast’s stock performance has shown sharp spikes and dips in share price, sometimes associated with controversial claims and questionable promotions about its *products*. In early 2007, Medifast’s stock took a sudden dip when CEO, Bradley T. MacDonald, quickly resigned his position. *Barron’s Magazine* had disclosed that he had placed postings on Yahoo financial boards under a pseudonym. (*Barron’s*, Jan. 8, 2007).

Perhaps due to these publicized controversies over its products and the promotional tactics of the CEO, little in-depth or focused analysis has been given to Medifast’s multi-level marketing *business model*. More recently, Medifast stock has shown a spike, related to dramatic revenue growth in the *Take Shape for Life* sector, which accounts for nearly all of Medifast’s growth and is rapidly increasing as a proportion of total revenue,

¹ The MLM model is under worldwide scrutiny as a disguise for business opportunity scams. Some have charged that the business has devolved into a form of Nigerian scam, originating mostly in the United States and Canada.

- The MLM business model and distributor payment plan, used by *Take Shape for Life* is currently banned in China, which treats it as an inherent fraud, as of 2005.
- The largest of all MLMs, Amway, was recently prosecuted for fraud in England, which sought to shut down Amway in that country. The UK Dept. of Trade and Industry revealed that 99% of the thousands of English consumers who invested as distributors in Amway UK, year after year, failed to earn a profit while the company promoted itself to British consumers as the “greatest income opportunity in the world.”
- Leaders of the MLM, GoldQuest, were prosecuted in Sri Lanka, Iran and other countries and recently arrested for pyramid fraud in India.
- One of the largest and fastest growing MLMs in the USA, YTB, was prosecuted for pyramid fraud in California.
- A large class action lawsuit is pending against Amway, charging that it is a massive pyramid scheme. The suit is led by the firms of Willie Gary and Boies, Schiller, Flexner.
- A fast growing MLM in Canada, Business in Motion, was recently the subject of a news exposé on the CBC news show, *Marketplace*, questioning whether it was a disguised pyramid scheme.
- The FTC in 2008 enacted a new rule to regulate Business Opportunity schemes. In a controversial ruling, the FTC accepted a staff recommendation to exempt MLMs as a separate and distinct form of business.
- MLMs are among the largest financial contributors to the Republican party. The founders of Amway are considered at the pinnacle of political influence and power.

Tipping Point into MLM

In the 3rd quarter of 2008, that trend at Medifast reached the tipping point in which *Take Shape for Life* accounted for 50% of the company's revenue. Medifast must now be categorized as a multi-level marketing (MLM) company, in the same league with Amway, Pre-Paid Legal and others. Its "business opportunity" offering is now treated as a separate and distinct business type by the Federal Trade Commission (FTC), under Section 5 of the FTC Act, which draws the line between legitimate direct selling and the operation of a pyramid scheme engaged in the sale of a bogus "business opportunity."

This business category includes one prominent MLM, Your Travel Biz.com (YTB), that was recently prosecuted by the California Attorney General for operating a "gigantic pyramid scheme" in violation of California Penal Code Chapter 9. § 327.² Both Medifast and YTB are members of the Direct Selling Association, the majority of whose members employ the MLM model.

My report examines and offers an opinion whether *Take Shape for Life* operates as an "endless chain" sales scheme, as defined in the California Penal Code, under which Your Travel Biz.com is being prosecuted. I conclude that Medifast is employing a marketing system that meets the definition of an "endless chain" outlawed in California and that the business model and practices in fact parallel those of Your Travel Biz.com.

Reasonable Causes for Suspicion

In the post Madoff era, which includes the Enron/Arthur Andersen scandals, extraordinary and singular growth by a company must now be viewed as a cause for scrutiny rather than an automatic assumption of market success. A sudden or extraordinary revenue growth that is not explicable by technology superiority, overall industry growth or any other verifiable market factor, should now be reasonably questioned as a possible signal of pyramid fraud. This is the same charge that was leveled at YTB, which had also shown rocket-like revenue growth.³

An accompanying sign of possible fraud is a company's explanation for its growth or profitability that is unfounded, erroneous, unintelligible, or based on secrecy. Enron, famously described as the "smartest guys in the room," claimed to have a unique – and incomprehensible – business model which it said facilitated its spectacular growth and profits. This proved to be little more than accounting fraud and pyramid money transfers.

² § 327. "Endless chain" schemes

Every person who contrives, prepares, sets up, proposes, or operates any endless chain is guilty of a public offense, and is punishable by imprisonment in the county jail not exceeding one year or in state prison for 16 months, two, or three years.

As used in this section, an "endless chain" means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme.

³ In only several years time, YTB enrolled a "sales force" of over 340,000 US consumer/investors and drew nearly 20,000 participants to its annual meeting in St. Louis. In the last year, the number of YTB "agents" grew 67%.

Bernard Madoff similarly claimed to have a trading system, which only he understood, that produced consistent, above-average returns regardless of market trends. His investor reports were described by clients as indecipherable. He has now confessed that his profits were only Ponzi money transfers.

Medifast has enjoyed what can only be described as astonishing growth in comparison to other companies engaged in the same business during this time and in a business field that is declining. In the last year, the *Take Shape for Life* sector grew 99% while sales volume in its industry declined. It accomplished this during one of the worst economic downturns in the American history. In a similar anomalous manner, the Medifast stock has shown extraordinary growth, rising nearly 60% while the Dow Jones Industrial average sank nearly 40%. All of Medifast's competitors have shown steep stock value declines, in accord with the overall stock market.

This report attributes Medifast's extraordinary and singular revenue and stock value increases to its use of the deceptive "endless chain" incentives offered to consumers. Medifast is marketing a misleading business opportunity in which its weight management products are bundled. The promotion of the bogus "business opportunity" drives product sales.

To account for this amazing performance, Medifast has made the logic-defying claim that that consumers become more "health and appearance" conscious during a Recession, leading them to buy meal replacement products! This is not supported by any evidence and is contradicted by academics and by past experience that links Recessions with poorer health and nutrition.

Further, Medifast attributes its growth to a claim that consumers "can substantially supplement their personal cash flow, in a difficult economic period, through direct sales in our "Take Shape for Life" program." This is also not substantiated. Medifast does not divulge actual incomes, costs, dropout rates or distribution of commission payments among the multiple levels of its sales force. Contradicting the claim is data analysis in this report that shows that only a tiny few who joined Medifast could possibly earn even the equivalent of wages of a part time minimum wage job.

The report on Medifast prepared in September 2008 used data through Q-2 '08. It showed that Medifast's revenue growth was driven almost entirely by increases in the *Take Shape for Life* sector, which offered consumers not only a diet program but a MLM "business opportunity." Indeed, the diet plan itself was inextricably bound to the MLM "business opportunity" offering. The offer of an "income opportunity" – based on endless chain recruiting – is woven into every sales pitch.

For example, TSFL Website description of its diet program states that it includes three key components:

- *Healthy Body* - physical health is the foundation of a happy and fulfilling life.
- *Healthy Mind* - how we feel about ourselves also affects long term Optimal Health.
- *Healthy Finances* - debt causes stress - and stress can take a severe toll on both your physical and mental health. By managing and eliminating debt, learning ways to budget, and or *seizing financial opportunities*, you further yourself on the road to Optimal Health. (italics added)

No other meal replacement company ventures into a customer's personal financial life as an integral part of its diet regimen. But *Take Shape for Life* boldly makes “finances” and “seizing financial opportunities” the third of just three critical aspects to its program and philosophy.⁴

Its prescription for how to achieve "healthy finances" is specific. It means signing up as a *Take Shape for Life* “coach”, an unpaid, independent distributor, authorized to recruit other coaches in an endless chain pay incentive plan. The meal replacement products and the income potential as a coach are inseparable.

Inexplicable Spikes

The *Take Shape for Life* sector accounted for 50% of Medifast revenue in the 3rd quarter of 2008, the last period in which the company supplied data to the SEC. Excluding the *Take Shape for Life* sector, Medifast actually declined in revenue, comparing 3rd quarter of '08 to the same period in '07. This put the rest of the company in line with the trends of other companies in the meal replacement business. However, the *Take Shape for Life* sector increased an amazing 99%, enabling Medifast to report to shareholders that it achieved robust growth during this Recessionary time.

A sudden spike in stock, singular in its industry group and during a Recession, requires a reasonable, market-based explanation. The chart below compares Medifast to other major companies in the same business:

Company	Stock Performance One Year	Stock Performance Year to Date
Medifast	+ 59%	+ 32%
NutriSystem	- 40%	- 6%
eDiets.com	- 48%	- 26%
Weight Watchers	- 58%	- 31%
Jenny Craig	Owned by Nestlé; does not disclose figures	
DJIA	- 36%	- 11%

Medifast's positive stock performance is anomalous and is in sharp contrast to its competitors, several of which are much better known and larger. The stock growth also defies the overall stock market.

The growth in stock value is matched by anomalous positive revenue growth in the midst of a national economic contraction.

⁴ In its training literature, the “trilogy” of “body, mind and finances” is consistently presented as the basic marketing message. For all who sell the TSFL meal replacement products, the income offer is integral to the promise of weight loss. For example, “...**financial health** has been identified as the final element necessary for long-term optimal health. The ability to help people quickly supplement their income can take the burden off of a struggling family's finances. For those committed to going all out to build this health network, there is practically unlimited financial reward!” (Training Binder, “Setting Your Business in Motion” ©2006 *Take Shape for Life*.)

http://www.getyouhealth.com/BizDocs/b1_setting_your_business_in_motion_0806.pdf

Company	Q-3 '07 Revenue (in millions)	Q-3 '08 Revenue (in millions)	Percentage Change
Medifast (total)	\$21.8	\$27.3	+ 25.22%
Medifast (Other Weight Loss Business Sectors)	\$15	\$13.7	- 8.7%
Medifast (<i>Take Shape for Life Sector</i>)	\$6.8	\$13.6	+ 99%
NutriSystem	\$183.1	\$162.7	- 11.14%
eDiets.com.com Inc.	\$6.8	\$4.8	- 29.4%
Weight Watchers	\$337.5	\$352.6	+ 4.47% ⁵
Total	\$549.2	\$547.4	- 0.33%

Every company, including Medifast's other sectors, lost revenue in the 3rd quarter of 2008 compared to the same period in 2007 or showed only a modest gain. However, the *Take Shape for Life* Sector, which is 50% of Medifast's current revenue, showed an astonishing growth rate of 99%. Without that sector, Medifast would have followed the industry with an average loss of revenue.

The one other major player in the weight management business that relates to Medifast is Jenny Craig. Recently acquired by Swiss food giant, Nestlé, the breakout data on Jenny Craig revenue trends are not disclosed. However, in a recent sales conference call, Nestlé stated,

“Finally in Nutrition, a word on Jenny Craig. This, together with Performance Nutrition, is the most sensitive of our Nutrition business to economic conditions. We have seen a trending down from the amazing performance that we enjoyed in the first quarter.”⁶

This indicates that Jenny Craig is following the industry in a downward trend, due to “economic conditions.” Only *Take Shape for Life* defies the national economy and differs from all its peers, and it does so in a spectacular manner – a 99% growth!

Implausible Explanation

In my view, just as the extraordinary and singular growth of Medifast's *Take Shape for Life* revenue and stock value is cause for scrutiny, its implausible explanation for this growth also fits the criteria for suspicion.

⁵ Weight Watchers, by far the best known and *broadly distributed* of meal replacement companies shows a slight revenue growth, however, its sales trends are downward. Q-3'08 revenue growth over the same period in (07) was less than half the growth rate of Q-1'08 over the same period in '07.

⁶ 2008 Nine Months Sales Conference Call Transcript, Conference Date: 23 October 2008 ; Chairperson: Mr. Roddy Child-Villiers, Head of Investor Relations , Nestlé S.A.
<http://www.nestle.com/Resource.axd?Id=C0F14074-84BB-4873-9AB5-98E36BEEB757>

In a December, 16, 2008 press release, announcing Q-3 sales growth, Medifast's board chair, Brad MacDonald stated,

“...during tough economic times, consumers turn their attention to improving their health and appearance.”

This is a remarkable explanation that conflicts with the sales trends of all other companies offering the very same products for “improving health and appearance” in the meal replacement field. It also conflicts with overall health trends during periods in which poverty and unemployment rise.

Recessions are accompanied by loss of health insurance, mental depression, and associated increases in obesity, not with increased “attention to health and appearance.”⁷

It is an astonishing assertion that during a period of dashed hopes, foreclosures, lost savings and delayed retirement, consumers actually spend more on “meal replacement” programs in order to improve their appearance. *Take Shape for Life* meals cost \$300 per month. At a time when many families can barely pay for groceries at all, would they make a priority of Medifast food products?

Reflecting Medifast's bundling of its food products with its other offering – an MLM income scheme – the Medifast chairman stated,

“In that regard, those who have lost weight on the Medifast program... can substantially supplement their personal cash flow, in a difficult economic period, through direct sales in our "*Take Shape for Life*" program.”

Conclusions

This report directly addresses the claim by Medifast that it offers a viable income opportunity that is fairly represented, a veritable life boat in troubled economic waters. This claim is the crux of its marketing program and the acknowledged source of its growth.

I conclude that Medifast, in fact, offers a misleadingly promoted income scheme that cannot possibly fulfill this promise. The income lure – that requires paying fees and buying *Take Shape for Life* products – is an endless chain scheme.

The vast majority of all consumers that Medifast enrolls in its “business opportunity” and who serve as the engines of its growth are doomed to fail. Those that “succeed” will do so on the investments and labor of those lured by the misleading promise. The income promise is based on success at endless chain recruiting, not retail selling. The environment for retail sales of meal replacement products is shrinking, as the sales of all other competitors and the overall market performance show.

⁷ See Jan. 9, 2009 Reuters news story, “Will Americans put on ‘recession pounds’?” that quotes the director of the Nutrition Sciences Program at the University of Washington in Seattle, “People ... are going to economize and as they save money on food they will be eating more empty calories or foods high in sugar, saturated fats and refined grains, which are cheaper.” The article directly contradicts the Medifast claim that “during tough economic times, consumers turn their attention to improving their health and appearance.” To the contrary, Recessions lead to increases in obesity, poorer health and reduced nutrition, (<http://www.reuters.com/article/healthNews/idUSTRE50805W20090109>)

The market for an “income opportunity,” however, is exploding. This is the most precious of commodities in a Recession and in the least supply.

An income opportunity based on personally retailing expensive products from a relatively unknown company in a declining market in the midst of a Recession will not “substantially supplement personal cash flow” as Medifast promises.

Medifast does not actually offer a viable income opportunity but the *illusion* of one, as portrayed in the endless chain mirage. As the FTC’s expert on pyramid schemes, Dr. Peter Vandernat explained, at all times the bottom ranks (of an endless chain pyramid) will hold the vast majority of investors. When income depends on endless chain expansion, those in the lower ranks, the great majority, are doomed to lose out.

Medifast’s website presents charts showing the potential for \$8,000 and \$20,000 incomes *per month*. It makes these representations and offers these lures without disclosing what percentage of the “coaches” could *possibly* earn these incomes or how many ever have. It withholds information from consumers on actual average incomes, the amount of total commissions paid to top levels, the drop out rates, and the expected business costs.

Like Enron’s special business model and Madoff’s secret trading system, Medifast dazzles its prospects with the classic and indecipherable MLM pay plan, showing the potential of an income with “no cap.” Yet, buried in the description are the codes for sending most of the commissions to the top ranks and using “compression” to capitalize on the labors of those faltering and churning at the bottom. The multi-tiered plan stacks ten levels of management upon the newest recruit, with each level geometrically expanding, but never discloses the market potential for any area. The number of coaches and the market for its meal replacement products are *always* treated as “unlimited.”

Waving high income figures at consumers in the midst of Recession will indeed attract extraordinary response and can produce greater interest than in those companies that still try to sell weight management products based on quality, price and efficacy. It is the bogus income opportunity of Medifast, not its weight products, that account for its singular revenue growth and stock rise.

The following report lays out the reasons why this marketing lure is not legitimate.

September, 15, 2008:

Expert Report on *Take Shape for Life*, a Division of Medifast, Inc.

Overview and Opinion

This report analyzes the business model and marketing practices of *Take Shape for Life* (TSFL), a division of Medifast Inc. (MED:NYSE) and their implications for Medifast shareholders.⁸ Medifast stock has shown a recent spike related to dramatic revenue growth in one sector, *Take Shape for Life*, which utilizes the “multi-level marketing” model. The report examines and offers an opinion whether *Take Shape for Life* operates as an “endless chain” sales scheme, as defined in California Penal Code, Chapter 9. § 327.⁹

My view is that *Take Shape for Life* does operate as an endless chain or pyramid scheme. I conclude that TSFL's business model and reward system – by their design, operation and promotion – meet the definition of an “endless chain” within the meaning of California Penal Code, Chapter 9. § 327.¹⁰

⁸ In recent years, Medifast's stock performance has shown sharp spikes and dips in share prices, sometimes associated with controversial claims and questionable promotions about its products' efficacy. In early 2007, Medifast's stock took yet another sudden dip when CEO, Bradley T. MacDonald, quickly resigned his position. *Barron's Magazine* had disclosed that he had placed postings on Yahoo financial boards under a pseudonym. (*Barron's*, Jan. 8, 2007).

Perhaps due to these publicized controversies, little in-depth or focused analysis has been given to Medifast's multi-level marketing sector, *Take Shape for Life*, which is largely responsible for the company's recent revenue growth and, once again, a sudden rise in stock value.

⁹ § 327. "Endless chain" schemes

Every person who contrives, prepares, sets up, proposes, or operates any endless chain is guilty of a public offense, and is punishable by imprisonment in the county jail not exceeding one year or in state prison for 16 months, two, or three years.

As used in this section, an "endless chain" means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme.

¹⁰ My view is based on years of research, writing and advocacy work with victims of pyramid schemes and significant experience with litigation involving this California statute. For example, in 2007, I was retained as consultant and expert witness by the Fresno County Counsel on behalf of the Defendant, Fresno County, California and various peace officers employed by the County. The case involved charges brought against a Fresno County Detective and other peace officers by an individual who claimed she was wrongfully charged and harmed in connection with a pyramid scheme prosecution. Fresno County sought to enforce the California state statute on “endless chain” schemes, Penal Code 327, against this person regarding a multi-level marketing company she promoted. I was asked to render an expert opinion as to whether the scheme operated as an unlawful “endless chain” sales scheme, as defined in California Penal Code, Chapter 9. § 327. This work required extensive research into not only the MLM scheme, but the California law and its history, intent and application. (Sharon Saunders, et al, Plaintiffs, vs. Detective Cynthia Knight, et al, Defendants, Case No. CIVF045924, REC LJO, United States District Court, Eastern District of California.)

Despite strong anti-pyramid scheme statutes in some states such as California and Section 5 of FTC Act that treats pyramid schemes as *inherently* “unfair and deceptive trade practices,” public understanding of the trickery and harm of endless chains, also called pyramid schemes or money transfers, has markedly *declined*. The internet is currently inundated with endless chain propositions, sometimes called matrix sales, investment clubs, “closed markets”, gifting clubs, and a host of multi-level marketing schemes. They purport to sell various items from travel services to gold coins to fruit juice and diet pills. In virtually all cases, investments are garnered from the public with promises of rewards that are dependent upon a continuous recruitment of new investors, i.e., the endless chain.

The inherent fraudulence of the endless chain marketing lure was succinctly and eloquently described by the U.S. Federal Trade Commission’s (FTC) own expert on pyramid schemes Dr. Peter Vandernat in his May 2001 declaration, on the MLM scheme, SkyBiz.com.

The proposed rewards set forth in a pyramid scheme are tied primarily to an ongoing ability to recruit others into a stated program and, thereby, a situation is created in which the proposed rewards cannot come true for the vast majority of participants. As recruitment continues, the number of people who are at or near the base of the recruitment structure grows very rapidly, often at an exponential rate for as long as a successful recruitment pattern is maintained. At whatever enrollment level new recruitment ceases, a number of layers of the most recent recruits cannot qualify for the proposed benefits precisely because their own “downlines” are either empty or have insufficient numbers. Moreover, given the nature of the recruitment pattern, these same people (those who are at or near the base of the recruitment structure) comprise the vast majority of participants. The resulting losses are not accidental; they are determined by the structure of a compensation plan that ties most of the proposed rewards to a participant’s ability to recruit others into the program.

In a pyramid scheme the large scale failure to obtain the proposed rewards is not postponed until market saturation. For as long as a successful recruitment pattern is maintained, the names of the most recent recruits change over time, but the percentage of members constituting the most recent layers of recruits does not appreciably change. At whatever enrollment the program may be considered, whether the total membership be large or small, saturation or not, the rules and implementation of the program ensure that the vast majority of members are not in a position to obtain the proposed rewards. For the promoters of the scheme, this feature always limits the liability for required payouts, while also favoring relatively few participants who are at or near the top of the structure. This description is typically true for all stages of recruitment, including those stages that are still far from market saturation. Also, in a pyramid scheme the number of people who lose money increases exponentially for as long as a successful recruitment pattern is maintained. From the perspective of consumer protection, it is always better that a pyramid scheme fail sooner rather than later.

In my view, TSFL’s income opportunity fits this definition. Its product promotions, inducements, promises, claims and rewards are inextricably tied, though sometimes disguised, to the endless chain recruitment-and-reward model described by Dr. Vandernat.

In structure and pay plan, TSFL is similar to the multi-level marketing scheme, Your Travel Biz.com (YTB), the 26th largest travel agency in America. The California Attorney

General is currently prosecuting YTB under California Penal Code, Chapter 9. § 327 and has publicly called it a “gigantic pyramid scheme.”¹¹

In the YTB scheme, participants pay an initial fee of \$499 and additional monthly charges to gain the status of “agent” which entitles them to sell travel services and to enroll other agents. Each agent can sell travel services directly to the public and can also gain discounts and other benefits from travel service vendors offered to YTB agents. They can also receive rewards when they enroll other “agents” and “overrides” on the travel purchases and sales of those they enroll and those that their recruits enroll in an endless chain of “agents.”

TSFL, like YTB, charges consumers a fee to gain special “credentials.” It charges between \$99 or \$299 to gain the title of “health coach.” Those who pay the higher \$299 investment are rewarded with 33% higher commission rate when they enroll others as coaches or clients.

Upon joining, the scheme immediately offers the new coach a \$100 “client acquisition bonus” for recruiting 5 new participants (participants are other coaches or retail customers, called “clients”) within 30 days.

The *client* acquisition bonus appears to reward retail sales. However, a second, related bonus program reveals it to be a pyramid recruitment bonus, part of TSFL’s larger endless chain reward program. Those coaches who pay the higher \$299 initial fee are rewarded with another \$100 *every time* one of their recruits achieves the same recruitment goal (five new participants in the first 30 days). This is called an “Assist Bonus.”

Since only the “coaches” can recruit, the Assist Bonus, only pays off when one has recruited other coaches, not clients. “Clients” merely buy the meal replacement program for their own personal use. They do not bring in new clients. The Assist Bonus is, therefore, a powerful incentive and a direct reward for recruiting other coaches. Recruiting five clients in 30 days can gain a \$100 bonus. But if five coaches were recruited during the same time period, another \$500 in potential reward becomes available.

Significantly, the recruitment bonus to those who pay the higher sign-up fees also includes a 50% lower threshold of *purchase volume* in order get the \$100 bonus, thereby making it easier to reach the recruitment goal by recruiting participants (referred to as “building structure”) rather than producing sales volume, i.e., recruiting more participants rather than selling more products to them.

These bonuses, therefore, induce a higher upfront investment and tilt the overall compensation program, right from the onset, toward recruitment of “coaches” (who also pay retail pricing) over retail selling to “clients” who pay the same pricing as coaches but cannot recruit others to the benefit of the upline recruiters.¹²

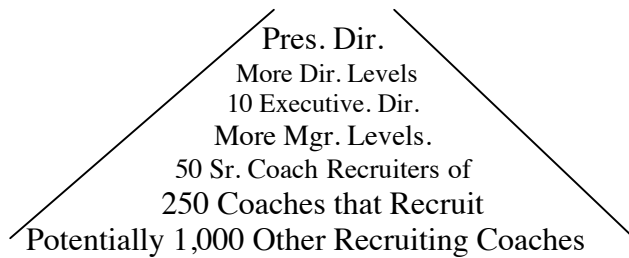
¹¹ <http://ag.ca.gov/newsalerts/release.php?id=1596>

¹² As in most other multi-level marketing schemes, total personal sales thresholds can also be reached to achieve these levels, that is, the level can be gained by only retail selling. However, the plan does place a fixed requirement that at least five other participants must be enrolled in order to gain “bonuses”. The five can be either “coaches” or “clients.” All pay the same prices to purchase TSFL products. The formula of the pay plan and the training eventually make clear that the most productive and quickest – and in practice,

The TSFL pay plan is based upon a 10-level pyramid. This heavily-layered hierarchy obviously makes no sense from a management perspective and is contrary to all current business trends of flatter and leaner management structures. However, when seen as a form of *pyramid leveraging* the TSFL plan is elegantly designed. The multiple levels produce an *ever-widening base*. Matched with a pay plan that *siphons most commission dollars to the top*, the seemingly unwieldy and inefficient structure maximizes the seductive lure and power of a pyramid when affixed to a sales program – to reward those at the top and to provide powerful incentives for those at the bottom to try to recruit their way to the top.

At the base of the pyramid and constituting the largest sector in the reward system are the newly recruited “coaches.” They are the *engines* of company revenue through their recruitment work, while also serving as major *sources* for revenue through their own purchases and payments of fees.¹³

After paying as much as \$299 initially and other related charges, each coach is authorized to recruit other coaches. The hierarchy of those who gain rewards when a consumer is enrolled extends upward on a classic “five get five” program (5-25-125-625, etc.).



When an individual coach enrolls five other participants with an aggregate purchase volume, the new coach moves to the level of “Senior Coach.” The TSFL pay plan then begins to offer escalating “bonuses.” “Manager” level is gained when 2 Senior Coaches are enrolled below,

thereby placing at least 10 other participants into that Manager’s Downline. Higher levels are gained when more participants in increments of five are enrolled under new Senior Coaches. When five Senior Coaches are enrolled, each with five participants below them for a total of 30 (25 participants and 5 Senior Coaches), the rank of Exec. Director is gained. At each level a higher percentage of total payments accrues from the total downline.

The pyramid moves toward its peak with four more levels. Regional Director sits above the Exec. Director. (each Exec. Dire. has 30 participants). The National Director has 3 Exec. Directors for a total of 93 participants below them. Global Directors have five Exec. Directors for a total 155 participants. The top rank of Presidential Director has 10 Exec. Direct.. with 310 participants. As will be explained further and emphasized in the

the only feasible – means to reach the upper level is to build “structure”, i.e., recruit coaches who recruit other coaches. In this manner, the participant will “construct” a pyramid below and move higher up the chain where far greater rewards are offered. The cultivation of new coaches “leverages” other people’s recruitment incentives to move up the ranks also and gain access to lucrative “bonuses” and “overrides” that are payable only to those in the top ranks. At any time a “client” can be converted to a “coach” and gain the chance to join the “endless chain” and receive “unlimited” rewards from recruitment.

¹³ Medifast does not disclose to shareholders how much of *Take Shape for Life*’s revenue comes directly from the payments made by the coaches. If the coaches are also buyers of the products on a monthly basis, they could constitute as much as 20% of company revenue all by themselves. (2,800 coaches purchasing \$300 a month of product for their own use, plus for sales and marketing purposes, plus entry fees, etc.)

rest of the report, the plan overwhelmingly inclines the “coach” to recruit coaches in these positions on the chain (building “structure”).

As the FTC’s Dr. Vandernat explained, the insidious deception of the endless chain is concealed with a promise of rewards that “cannot come true for the vast majority of participants.” TSFL entices consumers to become coaches with a deceptive promise of rewards that are based on the “endless” chain of more coaches. The very same promise of access to these rewards is offered to all coaches no matter how large the chain grows. In the imaginary world of the endless chain, the market is deceptively portrayed as “limitless.” The deception may also be stated as inducing and rewarding consumers to build an endless line of salespeople in a finite market. *The vast majority are doomed to fail. Those that “succeed” are doing so on the investments and labor of those lured into the money trap.*

As Dr. Vandernat explained, at all times the bottom ranks will hold the vast majority. The above chart illustrates this mathematical design. A Presidential Director may have as many as 300 (or more) coaches in the downline. Over 80% would be in the bottom ranks where they cannot gain “bonuses.” No matter how many Presidential Directors are in TSFL, there will be, correspondingly, hundreds of newly recruited coaches at the bottom. For the 250 at the bottom levels to achieve what the Presidential Director has achieved – by building “structure” – more than 75,000 new coaches would have to be enrolled below them.

Medifast and the California “Endless Chain” Statute

California’s anti-pyramid scheme law was passed in 1968, sponsored by State Senator (and later a famous Mayor of San Francisco) George Moscone and signed into law by then governor of California, Ronald Reagan.

The California law is based upon an *implicit* understanding of the “endless chain” as a classic form of trickery. The language is explicit – and the history of the law’s passage makes clear – that it intended to prevent the endless chain from being used as a marketing device for selling goods or for enticing consumers into an “income opportunity.”

Endless chain schemes typically blend the purchase of a product or service with the promise of income. Some stress the acquisition of a product for free or at a huge discount. Others induce product purchases by offering consumers “unlimited income,” “financial independence” and “freedom of time” through its “unique” income opportunity.

Endless chains, therefore, are both consumer scams, in the same category as “bait and switch” and business opportunity frauds in the same category as stock swindles and investment Ponzi schemes. The continuous recruitment of an ever-expanding base of new buyer/investors is their hallmark.

Take Shape for Life purports to offer both a steady part time income that offsets the \$300 a month cost of its products and a “full time” job opportunity that it claims can pay tens of thousands per month. Both opportunities are fundamentally based – though disguised – on the enrollment of consumers who enroll other consumers, etc.

Promoters of pyramid selling schemes often seek to weaken public understanding of the inherent fraudulence of the “endless chain.” A common defense of pyramid selling schemes is to characterize them as less a “business opportunity” than a “discount buying”

program. Most participants, it is often claimed, are not seeking high income (though it is promoted to them) but only join the schemes to get discounted or free products or services after they refer other participants to the scheme.¹⁴

It is clear that the authors of the California statute intended to outlaw this very type of chain referral marketing scheme in addition to those that blatantly promise the potential of “six figure incomes” to all. In his August 8, 1968 letter to Governor Ronald Reagan asking for his signature on the bill, Senator George Moscone offered a description of the most basic type of endless chain promotion that the law would outlaw and which had only recently appeared in the marketplace:

“For example, suppose that a buyer was promised a chance to obtain a product free of charge by referring five others and those five were each promised the same opportunity if each referred by more, and so on at the same rate of increase. After ten rounds the cumulative number of persons enrolled would be 12,207,03. Of course, these schemes never approach astronomical proportions. The saturation point is reached at an early stage... It follows that a large segment of the buyers participating in these schemes will suffer financial loss..”

The law aims at a *fraudulent marketing ploy*, not at products or even pricing. It is the way in which the scheme gains consumer investments or purchases that constitutes the scam. Quoting again the FTC’s expert, Dr. Vandernat, the endless chain scheme promises “rewards (that) cannot come true for the vast majority of participants.”

- The California law explicitly covers endless chains schemes that *sell products*. (“endless chain” means any scheme for the disposal or distribution of property).

Today, imbedding the pyramid money transfer in the *pricing of a product* or service is the *prevailing* method of disguise for endless chain schemes. Many consumers are misled by claims by pyramid perpetrators that “if a company sells a product, it can’t be a pyramid scheme!”

- It *excludes* businesses that straightforwardly pay commissions for sales made to consumers who are not part of the sales scheme, i.e., consumers who are not the coaches, distributors, agents, or IBOs, or whatever participants in the pyramid reward systems may be euphemistically called. (*Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme.*)

¹⁴ The Direct Selling Association, which represents most major multi-level marketing companies, recently lobbied the Federal Trade Commission to exclude MLMs from a proposed new consumer protection rule to regulate “business opportunity schemes.” The DSA has also made public claims that the documented 99% loss rates of consumers that join MLMs is not significant since few of the people who sign up as sales representatives actually try to make sales or to earn an income, DSA maintains. They only wanted products at the “discount” or for free, which is available only to those in the chain pay plan. The high drop out rates of 60-80% a year, according to the DSA, are not indicators of failure but to the *success* of participants in obtaining products at a discount after making a few referrals or having earned a small profit from enrolling others.

- In ensuring that legitimate direct selling is distinguished from pyramid selling, and that pyramid schemes could not be disguised as legitimate direct selling companies, the final law went through a crucial wording change. The last sentence had originally read,

“Compensation in this section, does not mean or include payment based upon sales made by such persons or participants.”

That wording could have *exempted* rewards that were laundered through product sales, thereby legalizing disguised pyramid schemes and leaving all consumer vulnerable to being recruited into sales businesses that use the endless chain income promise as a sales and purchase incentive.

The California legislature replaced this “loophole” with the wording,

“Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme.”

With the final wording, businesses that paid commissions on actual retail sales to real end-users were not included while those that laundered the payments and rewards through product purchases were covered. By shifting the exemption to actual *sales* (sales made to persons who are not participants), rather than to *persons* making sales (sales made by such persons or participants), a fundamental distinction was maintained. True retail sales are not affected but sales driven by pyramid recruitment (*salespeople* selling to *salespeople* who sell to *salespeople*) was recognized for what it is – an endless chain scam.

To end all ambiguity, the final version of the law also deleted the word *primarily* in describing schemes that pay rewards for recruiting new participants and are covered under the law. The final wording made it unequivocal that the law covered *any* business that employed the endless chain as a marketing device.

Earlier draft language of California’s “endless chain statute

1 SECTION 1. Section 327 is added to the Penal Code, to read:
2 327. Every person who contrives, prepares, sets up, pro-
3 poses, ~~operates, or aids in the operation of~~ *or operates* any
4 endless chain is guilty of a misdemeanor. As used in this section,
5 an “endless chain” means any scheme for the disposal or dis-
6 tribution of property whereby a participant pays a valuable
7 consideration for the chance to receive compensation *primarily*
8 for introducing one or more additional persons into participa-
9 tion in the scheme or for the chance to receive compensation
10 when a person introduced by the participant introduces a new
11 participant. *Compensation, as used in this section, does not*
12 *mean or include payment based upon sales made by such per-*
13 *sons or participants.*

Current California Law

§ 327. "Endless chain" schemes

Every person who contrives, prepares, sets up, proposes, or operates any endless chain is guilty of a public offense, and is punishable by imprisonment in the county jail not exceeding one year or in state prison for 16 months, two, or three years.

As used in this section, an "endless chain" means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme.

Final wording of California Penal Code 327 closed off loopholes for laundering money through product sales.

It prevented the operation of endless chain schemes that claim to be "product-oriented", while gaining sales with promises of endless chain rewards to salespeople

“Demand created by these schemes is the demand to obtain something for nothing plus a profit too. Accordingly, they detract from the free enterprise system ideal of competition based upon prices, on quality and on need for products and services.”

--August, 1968 letter sent by State Senator Moscone to Governor Reagan explaining the various problems that the new anti-endless chain law was seeking to address.

The final law has the definitive language:

“an "endless chain" means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant.”¹⁵

¹⁵ The “loophole,” which was removed from the California statute, was strongly promoted – and its removal vigorously protested – by one multi-level marketing company operating in California at that time. The MLM was Holiday Magic. It sold cosmetics and was owned by William Penn Patrick, also the owner of a training programs, Leadership Dynamics and Mind Dynamics. Patrick lobbied legislators to exempt any scheme in which payments and rewards were tied to product purchases.

The law ultimately treated this product-oriented model as merely a disguise for pyramid fraud. The law zeroed in on the endless chain lure that drove the product “sales” as a systematic swindle. The legislators saw that the fraud was in *how products were marketed*, not in the products themselves or the pricing. Tying the pyramid to a “sale” and “purchases” did not change the true nature of the fraudulent enterprise.

Take Shape for Life's Pyramid-based Business Model

To grasp the full significance of the TSFL program of endless chain incentives for coaches, it must be seen in the context of the overall business model of Medifast. Also, since TSFL employs the “multi-level marketing” mode, it is important to see it in the context of the larger MLM “industry.”

MLM is not just a business model but a distinct industry with its own Washington, DC lobbying organization, the Direct Selling Association (DSA). *Take Shape for Life* is a DSA member. Every MLM competes with all other MLMs for the sale of the one product they all have in common – *an income opportunity*. Many have strict rules prohibiting participants from joining other MLMs even though the ostensible “products” (soap, fruit juice, herbs, diet pills, etc.) are clearly unrelated. All MLM are more closely related by the “extraordinary” and “unlimited” income opportunity that they market than any of them are to other non-MLM companies that may sell similar “products.”¹⁶

In all MLMs the income opportunity is based on commissions sourced from an “unlimited” and ever-expanding base of recruits. For this reason, the legitimacy of the MLM industry is continuously under question. All publicly traded MLMs must include in their list of “risk factors” the potential of their business model being effectively outlawed.¹⁷

- The MLM business model is currently banned in China, as of 2005

Holiday Magic was later shut down and paid millions in restitution. It was prosecuted in the US by the SEC and by regulators in Europe as a pyramid scheme.

Today, exactly the same “loophole” to exempt “product-based” schemes is championed by the Direct Selling Association (DSA) of which Medifast is a member. In these schemes usually 30-40% of the product price (which is often already hyper-inflated) is transferred to upline recruiters – with most of that amount going to the top 1% – as each new participant “buys” the goods upon joining and participating. All new recruits (purchasers) are then urged to build their own “endless chain” of new purchaser/recruits below on whose “purchases” they will gain rewards. *Take Shape for Life* pays even more to its recruiters – 50% of the price of its goods with the great majority of that going to the upper ranks – while authorizing all new “coaches” to “build structure”, i.e., recruit more coaches endlessly.

¹⁶ Because all MLMs are actually a singular distinct type of business, regardless of products, some law firms specialize in representing them. The law firm of Grimes & Reese, P.L.L.C. is one of these. It lists *Take Shape for Life* as one its clients. Other MLM clients of Grimes & Reese include Burnlounge, Inc. which is currently being prosecuted by the Federal Trade Commission for operating an illegal pyramid scheme. See <http://www.ftc.gov/opa/2007/06/burnlounge.shtm>

¹⁷ Due to their questionably legal business model, the jeopardy that all MLMs are in – including those traded on stock exchanges and experiencing rapid growth – was highlighted in the recent, traumatic experience of the MLM, Your Travel Biz.com (YTBLA.OB). YTB was ranked as America's 26th largest travel services agency. No action had ever been taken against YTB by the U.S. Federal Trade Commission (FTC) or any other state Attorney General. Like *Take Shape for Life*, YTB is a member of the Direct Selling Association which claims to screen its members to ensure they operate legally and ethically. And, like *Take Shape for Life*, YTB is publicly traded on the stock exchange and must report its financials to the SEC. YTB has a reported "sales force" of over 340,000 and drew nearly 20,000 participants to its annual meeting in St. Louis. In the last year, the number of YTB "agents" grew 67%.

The YTB stock was trading at about \$1.80 on Aug. 3, 2008. The next day, news broke that the California Attorney General was suing YTB for violating California Penal Code, Chapter 9. § 327 – the endless chain statute – and the stock plummeted. A month after the announcement of the prosecution the stock sold for 71 cents, a drop of 61%.

- The largest of all MLMs, Amway, was recently prosecuted for fraud in England. The government of England sought to shut down Amway in the country. It discovered that 99% of all participants in Amway UK, year after year, failed to earn a profit while the company promoted itself to British consumers as the “greatest income opportunity in the world.”¹⁸
- Here in the USA, a large class action lawsuit brought by large and well established law firms in the United States is charging that Amway, the mother of all MLMs is a fraudulent pyramid scheme.¹⁹
- The MLM company, Your Travel Biz.com, a member of the Direct Selling Association with over 300,000 consumer participants was sued in August, 2008, by the California Attorney General for violating Penal Code 327, the endless chain statute.

Medifast is the only MLM company in the Meal Replacement industry and the only (primarily) Meal Replacement company in the MLM industry.²⁰ Its uniqueness in MLM has significance. Most MLMs offer products that are cheaper to produce and on which the schemes can make claims of “extraordinary” characteristics – patented, unique, “not sold in stores,” etc. Medifast sells *food* which cannot easily be promoted for having miraculous or instantly transformative powers, as “natural herbs” might be.

Because Medifast does not sell a “sexy” and “amazing” or “unique” product, the role of its income claims becomes even more central to its product sales. The role of its offer of an income is its main means of differentiating itself from the much larger and better known competitors such as NutriSystem or Jenny Craig, among others.

The Role of *Take Shape for Life* in Medifast

Though *Take Shape for Life*, which uses the MLM model, is half of the company’s total revenue and nearly 90% of its recent growth – and its “income offer” is its chief distinction among competitors – *the MLM model used by Medifast is only minimally disclosed to shareholders in SEC filings.*

Medifast divides its business into four distribution channels:

- | | |
|--|-----|
| 1. Website sales driven by advertising (called “direct”) | 48% |
| 2. Sales through medical doctors | 3% |
| 3. Multi-level Marketing, called “ <i>Take Shape for Life</i> ”. | 41% |
| 4. Brick-and-mortar Weight Control Centers | 7% |

The MLM sector is the fastest growing sector of Medifast with 72% growth in the first six months of 2008 over the same period in 2007. It grew from 33% of total company

¹⁸ See the 11/24/07 article from the *London Times* at <http://www.pyramidschemealert.org/PSAMain/news/TimesReportonAmwayTrial.html>

¹⁹ Jeff Pokorny and Larry Blenn on behalf of themselves and those similarly situated, Plaintiffs, v. Quixtar, Inc., James Ron Puryear, Georgia Lee Puryear and World Wide Group, L.L.C; Britt Worldwide L.L.C., American Multimedia Inc., Britt Management, Inc. Bill Britt and Peggy Britt, Defendants, Case No. C 07 0201, United State District Court, Northern District of California, Class Action.

²⁰ Many MLM companies, including Amway, sell some meal replacement products (bars or shakes, for example) but are primarily focused on other products such as soap, vitamins, herbs, etc.

revenue at the end of 2007 to 41% six months later. It accounted for 86% of Medifast's actual growth in the first six months of 2008 over the same period of 2007.

The sector of medical doctor sales declined in revenue. The brick-and-mortar sector grew robustly but is a very small part (7%) of total revenue. Internet sales (called "direct"), which is driven by advertising, is currently Medifast's largest sector (48%) but it grew only 5% year-over-year. *If these growth trends continue, the MLM sector (Take Shape for Life) is clearly slated to be the largest segment of Medifast very soon.*²¹

As noted, Medifast cannot claim a miracle product that prevents illness or is imported from an exotic rain forest and its food products cannot claim to be unique or substantially lower priced. *So, why is the MLM sector growing so rapidly?*

Medifast management answered this question unequivocally.

The Medifast 10Q stated, *"The growth in this segment correlates directly to the increase in health coaches."*

The number of active health coaches grew 87% to 2,800 at the end of the second quarter of 2008 as compared to 1,500 for the same time period in 2007, and up from 2,200 at the end of the first quarter of 2008.

Medifast's current growth is driven by TSFL's growth in "health coaches." Medifast's current growth in stock value, therefore – *over 150% since March 08* – is similarly determined by TSFL's growth in "health coaches."

Despite this extraordinary equation linking growth in the number of coaches and Medifast revenue growth and Medifast stock value growth, Medifast shareholders know almost nothing about these coaches, how they are recruited, or about the factors that determine future growth of coaches.

The Limits of Unlimited

On its "Opportunity" webpage *Take Shape for Life* tells consumers that there "is no cap on your income." Perhaps the coaches can grow their incomes forever, but *Take Shape for Life* surely cannot grow the number of coaches forever.

For example, if the 86% of Medifast's growth that came from *Take Shape for Life* in the first six months of 2008 over the same period of 2007 is based on the 87% increase in the number of coaches, then the number of coaches must continue grow at that rate for the

²¹ Medifast reported in its 10-Q for the 2nd quarter of '08 that it invested \$400,000 new dollars in ads during the first six months of '08 over the same period last year to drive the internet (direct) sales division. This produced \$1,204,572 additional revenue (5%) in that division over the same period the previous year. *One new dollar in advertising expense produced 3 new dollars (\$3) in revenue.*

In the same time period, the MLM sector, *Take Shape for Life*, increased revenue by \$9,044,790 (72%) while Medifast expended \$4,500,000 new dollars in "commission, and bonuses" to the company's "coaches." *One new dollar in commissions to the coaches produced 2 new dollars (\$2) in revenue.*

Missing from this disclosure, however, is how much was *expended by the coaches* to gain the new business. The dollars spent by Medifast on Commissions are "after-sale-rewards." The true costs of gaining a sale in the *Take Shape for Life* sector must also include the investments made by the coaches who are the actual "direct sellers" and would therefore incur the highest sales and marketing costs. It is precisely these types of costs that California's endless chain law seeks to protect consumers from, in addition protecting them from buying products or services on the false promise of "unlimited" income.

company's *revenue* to continue growing at its current rate. Medifast's rapid stock value rise seems to reflect a belief among some in the securities market that such growth can be sustained. *Can it?*

If growth in coaches were repeated over the next 5 years, at the last reported rate of 87%, there would be 64,000 coaches. In 10 years, there would be 1.5 million coaches! (2,800 x 1.87, compounded at the same rate for 10 years). Factoring the normal high drop out rates, the number of people joining Medifast as coaches would be in the millions! The number of people solicited to successfully enroll these millions would be in the tens of millions! *Whom would the multitude of coaches sell to?*

If Medifast's sustained its current revenue growth rate of 25% over a five-year period it would have total revenue of \$271 million. In ten year annual revenue at the same continued annual growth rate, total revenue would be \$827 million – about the size of NutriSystem Inc., today, one of Medifast's main competitors.

The diet and meal replacement market could conceivably support 25% annual growth for Medifast, compounded over the next 10 years. Such growth would be extraordinary and would clearly involve taking market share from competitors. However, if this growth requires a corresponding rate of growth among the coaches, it clearly is not possible.

Medifast's growth rate is limited under its business model, not because the market could not sustain this rate of market share expansion, but because *the market for coaches* cannot expand at this rate! Legitimate recruitment of coaches requires a viable income opportunity for the coaches, based on market potential. As the number of coaches expands, the available market and the potential income opportunity *diminishes*. This fact is the fundamental reason the California law targeted the “endless chain” as marketing or sales device. It offers what it cannot deliver.

Because Medifast increasingly relies upon an ever-expanding number of “coaches” to sustain growth, the MLM pay plan of *Take Shape for Life* becomes the *de facto* linchpin of the company's stock value.

As noted earlier, in my view, this pay plan meets the definition of an “endless chain” within the meaning of California Penal Code, Chapter 9. § 327. To say this another way, Medifast is hinging its business upon the “endless chain” incentive to induce people to work for it. It is rewarding them on a model that is *unsustainable* and that must *always* prevent large numbers of reaching the promised goals. Indeed it cannot be sustained except by *causing* these dashed expectations. For there to be some winners, there must a correspondingly much larger group of “losers”, those at the bottom that cannot be earning the large incomes, due to their position on the chain.

Medifast's Cover-up

To build a business on pre-determined failure by most of salespeople requires extensive *deception*, which Medifast is already engaging in and must intensify to produce higher recruitment rates for coaches. *Take Shape for Life's* MLM business model has inherent limits and liabilities, which are not disclosed Medifast shareholders. Though the company's growth depends on coaches, shareholders do not know from SEC filings about the coaches' productivity or profitability. Nor do they do know about their retention rates.

- Medifast offers no information on its website or in SEC filings about the actual number of coaches recruited in any time frame or their dropout rates. It only offers a count of “active” coaches at the end of a quarter. Therefore, the churn rate, if there is one, is not disclosed.
- The actual number of retail customers per “coach” is also not disclosed. Similarly, the company does not disclose the percentage of incomes of coaches that are based on personal retail sales versus “bonuses and overrides.”
- The average income of *all* coaches, active and inactive over and extended time, is not reported to shareholders or to prospective coaches.
- The percentage of annual revenue sourced directly from the coaches (their fees and personal purchases) is not disclosed.
- Perhaps most important, regarding the coaches’ profitability, the shareholders do not know how many coaches are in the various levels of the sales hierarchy and the proportions of commission payments made to each of the various levels of coaches.

The last figure about how commissions are apportioned by rank is crucial, since the pay plan offers extraordinary rewards to those in the top ranks only. If the data revealed how much of total commissions went to the various levels, it would reveal the true odds of success for newest recruits, i.e., how much money is left over to pay the latest recruits. Since the company depends on the steady recruitment of more coaches who join the bottom levels, it will always be the revenue produced by the newest recruits – who are always the majority – that sustains annual revenue.

- Currently TSFL recruits coaches without disclosing to the recruits the data on incomes averages, amounts and percentages paid to each level of the “upline”, dropout rates or average costs to do the business.²²

The most basic data related to the recruitment of coaches – what percentage of *Take Shape for Life* revenue is paid out as commissions to the coaches or what the total dollar number is – is not directly disclosed to shareholders.

That basic and crucial piece of financial data is buried within the general line item “Other Selling, General and Administrative Expenses” which accounts for 61% of Medifast Revenue. How much of that went to “commissions”?

Several additional calculations reveal that in the *Take Shape for Life* sector, Medifast pays out 50% of all revenue in commissions to the coaches.

- Medifast’s total Revenue for the six months ending June 30 was \$52,706,000. *Take Shape for Life* Revenue is stated as 41% of total Revenue, which is \$21,609,460.
- In the discussion of the “Other Selling, General and Administrative Expenses” in the latest 10Q, Medifast states that “*Take Shape for Life commission expense, which is completely variable based upon revenue, increased by approximately \$4,500,000 as*

²² Coaches can earn 15% on sales to other coaches or clients. If the average buyer pays about \$300 a month, the per-sale commission is \$45. This is only a gross income before all business overhead and sales and marketing costs expended to get the customer are deducted. By recruiting and selling to a coach, additional payments can accrue without additional labor or costs.

the Company showed sales growth of 72% as compared to the first six months of 2007.

- Therefore, if sales grew 72%, commissions would also. The dollar figure of that commission growth is stated as \$4,500,000. Therefore, when \$4,500,000 is divided by 72% growth, it reveals the last period's total commission payments. This equates to \$6,250,000. ($\$4,500,000 \div .72 = \$6,250,000$.)
- If last year's commissions were \$6,250,000 and they grew in the same time period by \$4,500,000, then this period's commissions were last year's total plus the growth, which equates to \$10,750,000 ($\$6,250,000 + \$4,500,000 = \$10,750,000$.)
- So, in the first six months of this year, the company paid out a total of \$10,750,000 in commissions to the coaches and TSFL's total revenue was \$21,609,460. Commission payout was, therefore, 50% of total revenue ($\$10,750,000 \div \$21,609,460 = 50\%$)
- One further verification of this 50% figure is determined by dividing the stated dollar increase in commission by the dollar growth in revenue in the same period. In the first six month of 08, the company said TSFL's revenue was 41% of total revenue and that this sector grew 72% over the same time frame of last year. That number works out to a growth of exactly \$9,044,790. It also reported that during this same time period over previous year, they spent \$4,500,000 in additional dollars for TSFL for commission and bonuses. Dividing the new money Medifast spent on commissions into the new money it gained in revenue, it equals exactly 2, that is, the new commissions were 50% of new revenue.²³

Medifast's Pyramid Pay Plan

The most important information that shareholders are not provided concerns not just the hard data on income averages, costs and "churn" levels of coaches *but the method by which Medifast pays the coaches*. As in all sales programs, the pay plan is a key to sales force motivation and behavior.

The *Take Shape for Life* pay plan has two key characteristics that not only determine the incomes for the average coach but also directly affect compliance with California's "endless chain" law.

1. The Upline Recruiters of *Take Shape for Life* are paid *more than twice as much as the actual salespeople per sale*. This is a structure completely in reverse from normal direct selling businesses, which pay the largest part of total commissions to the actual sales agent – per sale. It is the salesperson who is primarily responsible for making the sales and who has incurred the highest costs in the sales process (including finding the prospective customers and successfully making the sales) and, therefore, requires the greater financial incentive and deserves the greater financial reward – per sale. *A top-loaded pay plan that transfers most of the commission dollars to the recruiters at the top of the hierarchy – per sale – reveals that the pay plan is oriented to recruiting, not retail selling.*

²³ 50% payout in commissions is quite high in the multi-level marketing field, which supports the fact that *Take Shape for Life* must drive its business with an "income promise". As noted, the product is food, which cannot be said to be "unique", "amazing", and "patented" as so many other MLMs claim their products are.

2. The concentration of rewards to the top levels is exacerbated by the system of “roll-up” and “compression.” The published compensation plan describes the system, *“This plan uses roll-up and compression. Roll-up means that if a Coach fails to hit the minimum sales and recruiting requirements (i.e. is Bonus Qualified), his/her volume will “roll-up” and be added to the volume of the next Coach in the line who has met those requirements and is Bonus Qualified. Compression means that if you are Bonus Qualified to earn bonuses on sales volumes in your network (based on your rank), each Bonus Qualified Coach at the specific rank to the depth you are to be paid determines a level or generation as you move down a line. For example, if you are qualified to earn Executive Director bonuses on two generations of Executive Director organizations, your first generation Executive Director will be the first Coach in the line that is currently Bonus Qualified at that rank and your second generation Executive Director will be the next one who is Bonus Qualified at that rank. Unqualified Coaches in between are rendered “invisible” regarding compensation for that pay period and their volume compresses to first qualified Executive Director up the line.”*²⁴

The extraordinary significance of this system would likely not be grasped by a consumer that has just signed up as a coach. It is key driver for recruitment and an amazing reward for those in upper levels. Each level of the TSFL pyramid has specific requirements for both volume and structure. If the structure or volume weakens or declines (people buy less or quit the scheme), the rate of pay changes dramatically. And the money that is lost moves up the chain and is transferred to those above who remain “bonus qualified.” In this way, recruitment levels are enforced with financial penalties, and the rates of dropouts and losses in status that inevitably occur among those struggling in the lower ranks, directly benefit those above.

The pay plan includes payments to as many as 10 levels of “managers” above the coach that makes a sale. A complex formula is used involving 98% of the retail price, called ARD, for Adjusted Retail Dollar amount), and 50% of the ARD, called CV, for Commissionable Volume. (It is highly unlikely a new coach could decipher the formula and grasp its implications for recruiting and retailing and its relationship to overhead and selling costs.)

At the base of the pyramid is the new coach who makes a sale of *Take Shape for Life’s* “meal replacement” products. A month of these products, in round numbers, costs \$300. For making the sale of a month’s worth of diet products, the new coach receives 15% of ARD, about \$44, or 14.7% of the retail sale.

14.7% is a remarkably low commission for making retail sales. Avon and other direct sellers offer 50% gross profit margins. Out of that commission amount, the coaches must cover all selling costs and ongoing overhead for their businesses.

Medifast’s SEC filings reveal that the company expends 50% of its revenue on commissions to coaches. 14.7% goes to the salesperson making the sale. Where does the other 36.3% go?

²⁴ <http://www.tsfl.com/pdfs/comp-overview.pdf>

The pay plan formula offers escalating “bonuses” to those that recruited the coach and those that recruited the coach who recruited the coach, etc.

- *Assist bonuses*: \$100 cash payments when their personally recruited coaches also get five clients or other new coaches in 30 days);
- *Rolling Consistency Bonuses*: based on escalating volumes from other coaches, continued month to month;
- *Growth Bonuses*: paid on Commissionable Volume of orders placed by others in your “organization”;
- *Leadership Bonuses*: paid to Executive Directors and higher on the volume of business ordered through “generations” of Executive Director Teams in the “Health Coach Network”.
- *Generation Bonuses*: paid to Regional, National and Global Director levels, the bonuses are paid on increasing levels level through 5 “generations” of Executive Director Health Coach teams within your “organization.”
- *Elite Leadership Overrides*: paid to National Executive Directors and higher on large portions of a leader’s business (in some instances the entire business) and could mean as much as an additional 3% through more than 5 generations of Executive Director Health Coach teams within an organization.

All of these special bonuses and overrides are reserved to those in the upper levels of the sales chain, but ultimately most of the revenue on which they are based comes from the work of the lowest level coaches. They are the great majority of the sales “organization.”

To grasp the full significance of the incentive reward system offered to those who can rise to higher levels, consider:

- The pay plan overview states that an Executive Director is entitled to a “*Maximum of 30 % of CV on sales in your Health Coach Network starting on Level 1.*” This 30% CV equates to a commission of \$44 on a \$300 sale. That is the same amount that the new Health Coach that actually made the \$300 sale would be paid. The Executive Director is five levels removed from the new coach in management levels!
- The plan also allows the Presidential Director to get a 3% CV cut on the total sales of all level in the “downline.” On the \$300 sale made by the lowliest new coach that is \$4.41 piece of the action, about 10% what the salesperson made who did the work and incurred all sales and marketing costs. The Presidential Director is 10 management levels away from the sale and incurred no costs at all on the sale!

Though practically indecipherable to a new recruit, the *Take Shape for Life* pay plan is a perfect blue print for endless chain recruiting. The most pay – per sale – is transferred in the upper ranks. The higher ranks also gain commissions for a “wider and deeper” levels of the total organization, directing large amounts of total commissions to them. Getting to the upper ranks, where all this money is concentrated *requires a dedicated campaign of recruiting.*

Take Shape for Life’s “Other” Product: An Income Opportunity

The California law is aimed at preventing companies from using an “endless chain” reward plan to induce investments or purchases. Unlike other meal replacement programs, *Take Shape for Life* promotes “income” as an integral part of achieving success in losing weight. *The offer of an “income opportunity” – based on endless chain recruiting – is woven into every sales pitch.*

For example, this is how Jenny Craig, a direct competitor of TSFL, describes the philosophy of its diet program on its website:

- *Food* - A Healthy Relationship With Food
- *Body* - An Active Lifestyle
- *Mind* - A Balanced Approach to Living

Contrast that with TSFL Website description:

- *Healthy Body* - physical health is the foundation of a happy and fulfilling life.
- *Healthy Mind* - how we feel about ourselves also affects long term Optimal Health.
- *Healthy Finances* - debt causes stress - and stress can take a severe toll on both your physical and mental health. By managing and eliminating debt, learning ways to budget, and or *seizing financial opportunities*, you further yourself on the road to Optimal Health. (italics added)

Healthy finances as part of a diet program? No other meal replacement program ventures into a customer’s personal financial life as an integral part of its diet regimen. But *Take Shape for Life* boldly makes “finances” and “seizing financial opportunities” the third of just three critical aspects to its program and philosophy.²⁵

So how does the TSFL program teach you to have “healthy finances”? Reduce credit card use, live more frugally?

No. Its prescription for how to achieve "healthy finances" is quite specific:

Healthy Finances²⁶

- Financial freedom
- Enhanced lifestyle
- No limit to your earnings potential
- Earn rewards commensurate with your efforts

In other words, signing up for TSFL coach work is the means of achieving “healthy finances” and healthy finances are one of the three keys to success in losing weight and reaching “optimal health.” The TSFL program involves not just dieting and exercise but also making money as a TSFL coach. The income offer is woven in with the meal

²⁵ In its training literature, the “trilogy” of “body, mind and finances” is consistently presented as the basic marketing message. For all who sell the TSFL meal replacement products, the income offer is integral to the promise of weight loss. For example, “...**financial health** has been identified as the final element necessary for long-term optimal health. The ability to help people quickly supplement their income can take the burden off of a struggling family’s finances. For those committed to going all out to build this health network, there is practically unlimited financial reward!” (Training Binder, “Setting Your Business in Motion” ©2006 *Take Shape for Life*.)

http://www.getyouhealth.com/BizDocs/b1_setting_your_business_in_motion_0806.pdf

²⁶ http://www.tsfl.com/corporate/opportunity_whyunique.asp#_

replacements. The two – the meal replacement products and the income potential as a coach – are inextricably bound together.

At the Bottom of the Pyramid: The Coach

According to TSFL’s program, signing up as a coach is a way to reach “healthy finances”, a key element in its weight control program. Coaching work offers “financial freedom and enhanced lifestyle,” it states. It claims also to offer “unlimited earnings potential”, determined “only by your own efforts.”

Does it?

Medifast does not provide a profile of the financial condition of coaches in SEC filings. The TSFL website offers little detail either. Consumers who are solicited to join TSFL as coaches are not given data on average incomes, turnover rates or business costs. Some closer analysis can shed some light, however.

For example, Medifast reported at the end of the second quarter of 2008 that there were 2,800 “active” coaches (no data is offered on how many are “inactive”). With further calculations explained earlier in this report, it was determined that TSFL paid the coaches \$10.75 million in commission on their own purchases and their sales during the first six months of 2008. This is a mean average of \$148 a week gross income, before all business and marketing and sales costs and taxes – *considerably less than what a part time job at minimum wage job offers.*

But, the real income *for most coaches* must be *much lower* than this. As shown earlier in this report, 65-70% of the total commissions paid out by TSFL goes to the ranks above the basic coaches. So, most commission dollars had to have been paid to the much smaller group at the top, causing a skewed average, weighted to the top. A *median* average income level, showing the point at which half make more and half make less, therefore, would be far lower.

The TSFL website offers a chart illustrating incomes of between \$8,000 and \$20,000 per month. In reality, only a tiny fraction of one percent could possibly earn such incomes (see chart below). A more realistic question is how many TSFL coaches earn might earn at least more than what a part time person earns at minimum wage? For example, we can test to see how many coaches could earn a modest \$500 per week in *gross* revenue, before expenses are deducted?

The calculations show that the highest possible number of coaches that could earn just \$500 a week is only 829 coaches out of 2,800. If just 829 earn \$500 a week, all 1,971 others would earn zero!²⁷ So, in reality, *far fewer* than 829 could *possibly* earn even a modest \$500 a week, *before all expenses.*

²⁷ The figure is arrived at by dividing \$500 into the mean average weekly income of \$148 to get .296 which is multiplied by 2,800 to get the number of 829 coaches. To test this number, multiply 829 coaches x \$500 a week x 26 weeks. That figure is equal to the *total* commissions paid during the period: \$10.75 million (rounded). In other words, if 829 coaches earned just \$500 a week, *all the other coaches could earn nothing at all.*

Note: the mean average weekly income of \$148 is arrived at by dividing the total commissions of \$10.75 million for six months by the number of coaches during that time – 2,800. That figure is divided by 26 weeks.

The *Take Shape for Life* website shows scenarios in which coaches earn \$8,000 and \$20,000 per month. The mean average income for coaches is actually \$148 a week with the great majority earning far less. A simple statistical analysis reveals that the maximum possible percentage of coaches that could earn \$8,000 (the lower figure) is 8%. If they earned that amount, the other 92% would have to earn Zero!



Skills to Learn for Each Strategy

Client Focused (\$100 - \$7,500 / month)	Client & Team Building Focused (\$1,000 - \$25,000+ / month)*
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Illustration of income averages is in the *Take Shape for Life* binder, “Setting Your Business in Motion” ©2006 *Take Shape for Life*.
Reality Check: Mean average monthly income for all coaches is \$640, with the great majority earning far less. Taking the midpoint in the illustrations above, \$3,800 for client focus and \$13,000 for team builders, the data shows that the maximum percentage that could earn these incomes is 17% and 5% respectively. If those percentages did earn the illustrated examples, all the other coaches would have to earn Zero.

The Costs of Coaching

On the other side of the ledger from average incomes are all costs associated with the TSFL coaching business. Under California’s endless chain statute, the costs that a consumer incurs in pursuit of an “endless chain reward” are described as follows:

... a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant.

As noted, Medifast pays the coaching network 50% of its revenue when it makes a sale. SEC filings do not show what percentage of that revenue the coaches – who are independent contractors – expended. The essence of endless chain fraud in a sales scheme involves inducing investment by consumers – which profit the sales company – while offering rewards that it cannot deliver. The *design of endless chain plan* and an *individual’s position on the chain* determines the payment of rewards to most participants, not their individual efforts or talents. Rewards are based on *position* on the chain. Most will, by design, be in the bottom. The only way all who invest could be rewarded is if the chain’s expansion could continue “endlessly”, which it cannot. Hence a law against such reward schemes.

What are those costs? Or, in the language of California’s law, how much “valuable consideration” does a coach pay for the “chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to

receive compensation when a person introduced by the participant introduces a new participant”?

TSFL literature makes no estimates of costs, though it does project potential income. Based on the costs of selling and marketing, the true costs could be substantial, including:

- Entry fees of \$299 or \$99
- Costs for training and certification, if that is chosen
- Inventory expense for sales purposes (a one-month supply of products is about \$300)
- Marketing materials, advertising, business cards, etc.²⁸
- All sales costs, i.e., telephone, car expenses, computer, attendance at meetings, including perhaps the annual meeting of TSFL, which has a registration fee of about \$400, not counting hotel and travel and meals.
- As in all self-employment, accounting, office and tax expense.

From a mean average income for the TSFL coaches – which is somewhere far below \$149 a week – *all* these expenses must be *deducted*.

Coaching Business Realities

The economic realities of TSFL coaches call into question the validity and the integrity of Medifast’s solicitation of consumers to financially invest in this work.

The pay plan overwhelmingly rewards building a “structure”, that is, recruiting others in an endless chain. This is achieved by authorizing *all* coaches *forever* to recruit others, thereby compounding the benefit from recruiting a coach over a selling product directly retail client. The very model of endlessly proliferating coaches in any geographic area (who are theoretically all competing with one another for retail “clients”) reveals that the play plan is actually based upon pyramid recruitment, not retailing. The growth of retailers in any market obviously dilutes and diminishes the sales potential in that market for each new coach.

If the plan is based on pyramid recruiting, it similarly dilutes recruiting potential as it expands. And as long as it operates, such a plan must, by design, always place the vast majority in the bottom ranks where recruitment-based rewards are not available.

Using an endless chain lure to solicit consumers places the entire Medifast program in jeopardy of violating California’s and other state’s laws against endless chains, pyramid schemes and deceptive trade practices, in my view.

1. The offer of just 15-20% gross profit to the new coaches to bring in retail business makes sustainable retail sales virtually unfeasible. Only those who build a large “downline” or, in theory, achieve extraordinary individual sales can gain higher rewards for sales work.
2. The average cost of marketing and selling, the churn rate of coaches, and the true amount of time required for sales and marketing are not revealed to the new coaches. Without this basic information, how could they know whether the income offer was valid? Withholding this information from consumers makes the Medifast coach solicitation program a questionable “business opportunity” scheme.

²⁸ Ads placed by *Take Shape for Life* coaches are frequently placed in local newspapers.

Take Shape for Life allocates 50% of its revenue to the entire coaching network when a sale is made. This 50% is taken from the consumer who buys the program from the coach. The coach that actually makes the sales – and who serves as the independent middle man – may earn only 15-20%. How much did it *cost* the coach to get the sale?

In the Medifast “direct” sector which uses advertising to locate prospects and sell them products, the company expends 41% of that sector’s revenue on advertising for it to generate those sales. That indicates a high cost required to actually make a direct sale.²⁹ Acting as independent contractor, the *Take Shape for Life* coaches face similar costs. They too are making “direct sales.”³⁰

Additionally, *Take Shape for Life* coaches face extraordinary competition; they represent one of the smaller players in the meal replacement business with a less known brand; and they enjoy no price advantage over competitors.

These high cost factors indicate that the feasibility of sustaining a retail sales coach business is highly questionable, and at best difficult and costly. The only feasible income path on a sustainable basis is to build a “downline” and seek “bonuses and overrides” derived from *recruitment* activity. *Only a tiny few could be successful, taking that path.*

Summary Conclusions:

- *Take Shape for Life* has concealed an endless chain marketing scheme within its “coach” sales program. Among the means of concealment, it obscures the distinction between salespeople (coaches) and retail customers (clients) and presents a compensation plan that obscures the requirements for endless chain recruitment.
- In my view, the *Take Shape for Life* income opportunity meets the definition of an endless chain within the meaning of California’s “endless chain” statute.
- *Take Shape for Life* misleadingly recruits consumers into its coach “business opportunity” by withholding key financial information, deceptively portraying income levels, and disguising the plan’s reliance upon promotion of endless chain recruitment.
- Key information about the limits and liabilities of reliance on its coach recruitment program have been withheld from Medifast shareholders. In light of the Medifast’s reliance on the coach sales program, for revenue growth and share performance, the data and facts that shareholders should reasonably have include:
 - ✓ Total amount of revenue sourced directly from the fees and purchases of coaches,
 - ✓ Growth requirements of the number of coaches in order to grow *Take Shape for Life*’s revenue over a 10 year period,
 - ✓ Turnover and retention levels of coaches,
 - ✓ The actual number of coaches vs. clients,

²⁹ Medifast reported in its Q-2’08 SEC filing that it paid out \$10.4 million in “advertising”. Assuming this is primarily to drive its internet (called direct) sales, and those sales were 48% of total revenue or \$25,298,880, then Medifast spent 41% of that sector’s revenue on advertising for it to generate those sales. That sector grew only 5% in the time period, and ad costs grew 4%.

³⁰ The high selling costs in the diet field are exacerbated by the short term nature of customer purchasing, requiring continuous marketing for new customers. For example, NutriSystem Inc. reported in its 10K that its customers uses its products on average only for 10-11 weeks.

- √ The average number of retail customers per coach.
- If consumers were given full and factual information about the realities of the TSFL coach “business opportunity,” recruitment levels would likely be negatively affected. These facts would include:
 - √ *Median* income averages and the inclusion of *all* coaches per time period, “active” and “inactive.”
 - √ Allocation of all commissions by percentage to the various levels on the TSFL sales hierarchy,
 - √ Disclosure of the numbers and percentages of coaches at each level of the TSFL sales hierarchy,
 - √ Actual average costs related to operating a retail sales business for TSFL coaches.
 - √ Historical turnover and retention rates
 - √ The existing number of coaches in any geographic area a coach is solicited in.
- Medifast’s solicitations of consumers that claim to offer “*Financial freedom... Enhanced lifestyle... No limit to earnings potential... rewards commensurate with efforts*” are cruelly misleading.
- The endless chain design of the coach recruitment program, the top-loaded and recruitment-oriented pay plan, the low profit rates for initial retail sales, high selling costs, among other factors which the company obscures, result in – and cause – the claims and promises related to a retail-based income opportunity to be unfulfilled for the great majority.