

HERBALIFE: “A LEVEL OF INAUTHENTICITY” – “AN EVENTUAL DECEPTION”

TOP HERBALIFE DISTRIBUTORS AND MEMBERS OF COMPANY MANAGEMENT ADMIT THE REALITY OF THE HERBALIFE BUSINESS OPPORTUNITY

In October 2005, a meeting of senior and mid-level Herbalife distributors, along with members of Herbalife’s board of directors, corporate management, and corporate staff, was held in Anaheim, California and recorded on video by Herbalife. The meeting took place on the eve of the “Herbalife University” weekend—a large training event for Herbalife distributors that was organized and hosted by the Company. Several members of the Company’s management—including Chairman’s Club member Leslie Stanford, who was then on the board of directors, as well as Senior Vice Presidents Rob Levy and Bruce Peters and Vice President Mike McKee, who are all still with the Company—were present and participated in the meeting.

The video depicts top Herbalife distributors, together with executives and a then-board member, having what is stated to be “a very honest and open conversation” about “the reality of our business.” During that conversation, participants, led principally by Chairman’s Club member Stephan Gratziani, corroborate much of what Pershing Square has said about the Company, including that (1) the vast majority of Herbalife distributors join the Company to pursue the business opportunity, (2) recruits are deliberately misled about their financial prospects, (3) “a very large percentage” of distributors who have reached the level of Supervisor and 90% of distributors who have not reached the level of Supervisor fail and quit the business every year, (4) distributors are trained by their upline and incentivized by the Herbalife compensation system to focus their efforts on recruiting new distributors into the scheme rather than selling Herbalife products to retail customers outside the distribution network, and (5) the Company’s business model is fundamentally based on distributors buying volume points from

the Company in order to qualify or requalify for recruiting rewards, rather than on retail customers buying Herbalife products from distributors.

Pershing Square strongly encourages investors, shareholders, analysts, regulators and other interested parties to watch the entirety of the video. At the outset, we highlight just a few of the most remarkable statements:

- “We sell people on a dream business, that they can make it. Yet deep down inside, what do we really know? Yeah. We know that the reality is that most of them aren’t going to make it.” (Disc 1, 1:00:16.)
- “Who wants to bring their family into a struggle to make it? Who wants to bring their family into an eventual deception?” (Disc 2, 7:20.)
- “We tell people, hey, you know, sign on the dotted line, you know, start working from home, it’s going to be unbelievable, you’re going to have this incredible life. . . . So there really is this situation or this level of inauthenticity that’s there.” (Disc 2, 8:28.)
- “The Herbalife business model is based on distributors purchasing volume from them. . . . The Herbalife business model, at this point in time, is not based on customers purchasing, it’s based on distributors purchasing volume.” (Disc 2, 14:34.)
- “These sixty thousand people [whom the speaker lost as distributors over the preceding five years], primarily, why do you think they came into the business? Primarily? Primarily? Opportunity! Money! Right?” (Disc 1, 46:05.)
- “[S]uccessful people in retailing in our business, it’s a very small percentage.” (Disc 2, 28:08.) “The majority of our people have a difficulty in selling products, in general.” (Disc 2, 29:46.)
- “‘Fake it ‘til you make it.’ Some of us got so good at faking it, we forgot to make it!” (Disc 1, 54:04.)

The video demolishes any suggestion by the Company or its defenders that deceptive recruiting practices and misleading income claims are the work of “a few bad actors” in the Herbalife distributor ranks. It confirms that top distributors work together with the

Company to develop new methods to mislead large numbers of unwitting recruits, and then train their downlines to use and proliferate those deceptive practices. And it reaffirms that, in practice, the Herbalife compensation system incentivizes distributors at all levels to focus their efforts on recruiting new distributors into the scheme and encouraging those recruits to purchase large quantities of inventory, rather than selling Herbalife products to genuine retail customers outside the distribution network. In short, the video confirms that Herbalife is a pyramid scheme and that those at the top—including senior distributors and Company management—work together to systematically fleece those at the bottom.

THE INTRODUCTION

The video begins as participants are checking in and finding their seats. About four minutes into the video, senior distributors Debi Katz and Meg Lile move to the podium at the front of the room for a brief introduction. Katz and Lile tell participants they had been “hand-picked by [their] upline Prez [President’s] Team,” and then they conduct a sort of roll call, asking how many participants have been in the business less than one year, less than two years, and so on. Toward the end of the roll call, Katz and Lile identify by name several senior distributors in the back of the room, including Leslie Stanford, who was then a member of Herbalife’s board of directors and who was then and continues to be a member of the Herbalife Chairman’s Club. Stanford tells the room that she will have been in the business 25 years in December.

Katz and Lile also identify Herbalife Senior Vice President Rob Levy, Senior Vice President Bruce Peters and Vice President Mike McKee—all Herbalife executives in Sales & Marketing and all still with the Company. Katz and Lile then tell participants, “In the back we do have a lot of the corporate staff here. Um, they’re here because of you guys. Um, they’re committed to your success and to what’s coming out of this weekend, this weekend.” (Disc 1, 9:39.)

Approximately ten minutes into the video, Katz and Lile begin to describe the discussion that is about to take place. They promise participants “an extraordinary conversation for possibility, and moving our businesses forward” (Disc 1, 9:54), and tell participants that “[i]t’s really healthy to step back for a minute and really look at your business and to analyze

what works and what doesn't work" (Disc 1, 10:09). They say that what participants are about to learn originated in a series of conversations "around the world" among top distributors who "all got together, a group of us" to find new ways to run successful Herbalife distributor organizations. (Disc 1, 10:20.) They recognize that "Herbalife business isn't easy all of the time" and "we struggle," so "[w]e looked at it like, there has to be a way that we can build our businesses and go forward without the struggle." (Disc 1, 10:50.)

STEPHAN GRATZIANI TAKES THE PODIUM

Approximately thirteen minutes into the video, Katz and Lile call up the evening's main speaker—senior Herbalife distributor Stephan Gratziani. Gratziani was then a member of the 30K President's Team (Disc 1, 13:57), and is currently a member of the Chairman's Club.¹ Before bringing Gratziani to the podium, Katz and Lile assure participants that "[t]he guy has operated inside of integrity in building his Herbalife business." (Disc 1, 13:45.) Then Gratziani moves to the podium.

Gratziani begins by reaffirming the Company's involvement in organizing the meeting, asking participants, "How many of you were on the tour today?" He tells them, "We can thank the Company for that." (Disc 1, 15:00.) Gratziani says that "the title of this is kind of the pre-meeting to the University." (Disc 1, 15:25.)²

Gratziani explains that the purpose of the meeting is "to kind of look at the reality of our business" (Disc 1, 15:35), and he admits that "[t]his type of a conversation is not something we have very often in meetings. You know, in meetings, most of the time it's to give a pitch on something." (Disc 1, 16:25.)

GRATZIANI'S RAGS-TO-RICHES STORY

About seventeen minutes into the video, Gratziani begins to recount his own rags-to-riches story—a common feature of presentations by top Herbalife distributors. Gratziani describes his discovery of Herbalife fourteen years earlier, and tells recruits it was "almost

¹ See Exhibit 1.

² It appears that Gratziani is referring to the Herbalife University event hosted by the Company in Anaheim, California in October 2005.

magical” for him to “join[] this company where there was and is just so much excitement, and just so much unbelievable results with the products and so much money and income and, you know, recognition and lifestyle and just, you know, the dream business for people.” (Disc 1, 18:00.)

Gratziani tells the audience that the key to his initial success was focusing his efforts on recruiting new distributors into the scheme:

I knew one thing for sure, is that we had something called Tuesday/Thursday/Saturday and that I could count on those meetings being there, and that I would just try to get as many people into those meetings as possible. And somehow, some way, I had an organization that started. People joined. People joined, people made decisions to become Supervisors, people went to larger events, saw the bigger picture of Herbalife. Some of them stayed, many of them left, but by some kind of magic way, I ended up with an organization. I ended up with a group of people that were, like me, committed to building a business. (Disc 1, 20:30.)

Of course, the fundamental difference between a pyramid scheme and a legitimate multi-level marketing company is that, in a pyramid scheme, the compensation structure “tends to induce participants to focus on the recruitment side of the business at the expense of their retail marketing efforts.” *Webster v. Omnitrifit Int’l*, 79 F.3d 776, 782 (9th Cir. 1996); *see also* Dr. Peter J. Vander Nat & William W. Keep, *Marketing Fraud: An Approach for Differentiating Multilevel Marketing from Pyramid Schemes*, 21 J. Pub. Pol’y & Marketing 139, 144 (Spring 2002) (“If an organization sells goods or services to the public and the participants in the organization obtain monetary benefits from (1) recruiting new members and (2) selling the organization’s goods and services to consumers, the organization is deemed a pyramid scheme if the participants obtain their monetary benefits primarily from recruitment rather than the sale of goods and services to consumers.” (Citations omitted)). Gratziani does not attribute his early success to selling Herbalife products at retail.

About twenty six minutes into the video, as Gratziani describes his own struggles as a mid-level distributor, he brings the focus back to “the reality of our business,” which is, as he says, “the reason why we’re here tonight.” (Disc 1, 26:20.) He reiterates that having “a realistic conversation” about the “ongoing struggle to grow the business, maintain the business”

is “not in our normal way of doing things.” (Disc 1, 26:50.) Indeed, “[t]here are some people that if they heard that we were talking like this in a room, you know, I would have to have a bulletproof vest on right now, you know what I mean, because we have a tendency sometimes to only look at the good side of things, and to kind of highlight the good stories, the quick stories.” (Disc 1, 27:16.)

Gratziani describes a time in 1999-2000 when he was a struggling mid-level distributor thinking about leaving Herbalife. He saw others around him quitting, including long-time members of his downline:

It’s almost a painful experience to see all of the good people that I’ve lost over the years that invested literally years of their lives into a business and then they left. It’s . . .it’s . . . it’s, you know, . . . if I really think about it, and some of them were close friends, that became close friends through doing the business.

(Disc 1, 29:25.) As a result, Gratziani says he decided in 1999 that, if he was going to stay with Herbalife, he would have to “do something that was going to change it all” because it “wasn’t interesting for me to spend, you know, another three years or five years or ten years doing what I had done the last nine years to produce more or less the same result.” (Disc 1, 30:00) So he “made a commitment to look at doing the business, not in a different way, but maybe starting to inquire on what wasn’t working for me.” (Disc 1, 30:30.)

Gratziani explains that his problem was that, although he was focused on recruiting, he was not doing enough to train his downline distributors how to recruit, and how to train their own recruits, and so on. Gratziani offers “kudos” to “Kurt and Cindy O’Connell, because they brought a concept of mentoring and a concept of a business plan and following a business plan, and, to be perfectly honest with you, it was almost revolutionary for me. I was someone that basically was just, you know, recruiting and building an organization and very rarely stopped to think about taking care of the organization that I had.” (Disc 1, 30:49.) As Pershing Square has argued, including in its profiles of top distributors like the O’Connells, which are available at www.herbalifepyramidscheme.com,³ the only way Herbalife distributors

³ The profile of the O’Connells is available at <http://www.herbalifepyramidscheme.com/perpetrators/kurt-cindy-oconnell/>.

have any hope of making money is to develop a regimented system to (1) recruit large numbers of distributors into the scheme, (2) push those distributors to invest substantial amounts of money as quickly as possible, and (3) train and equip those distributors to recruit still more victims into the scheme (which the Herbalife compensation system incentivizes them to do).

Gratziani says that he went so far as to stop recruiting until he could figure out “what was missing and what I could bring” that would allow his downline to become more profitable. (Disc 1, 31:24.) He quickly adds, “Don’t take this that you should stop right now recruiting, I could also get shot for that if you ever left here and said that.” (Disc 1, 31:38.)

Gratziani says that when he followed the O’Connells’ lead and introduced a “business plan” and certain “concepts and ideas” to his downline, “my organization grew like crazy, my income grew like crazy.” (Disc 1, 34:15.) He further confirms the importance of recruiting when he quips, “it’s better to have, you know, six thousand Supervisors in your organization than it is to have two—that’s one of the things I learned, OK? More is better in that way.” (Disc 1, 36:11.) But, as Gratziani tells the story, even as his organization grew, he remained frustrated with certain other metrics, especially failure rates, and he became “focused on changing those statistics.” (Disc 1, 37:16.)

FAILURE RATES

Gratziani begins his discussion of the extraordinary rates at which Herbalife distributors fail and quit the business by telling his audience that “there is a reality to the statistics in our Company” (Disc 1, 37:23), and “we know that literally we lose a very large percentage of our Supervisors every single year.” (Disc 1, 37:53.) He asks how many of the distributors in the room also lose a large percentage of their downline Supervisors every year. Virtually every hand in the room goes up. (Disc 1, 38:05.)

He goes on, “we know that we lose, for the ones that aren’t Supervisors, basically nine out of ten people. So for the distributors that don’t make it to Supervisor, we’re losing ninety percent of our distributors.” (Disc 1, 38:06.) This statistic matches precisely Herbalife’s 2005 Annual Report, where the Company disclosed that between January 2004 and January 2005

“more than 90% of our distributors that are not supervisors turned over.”⁴ As Gratziani says, “that’s kind of the reality of this.” (Disc 1, 38:20.) Gratziani’s estimate of more than 90% turn-over accords with the Company’s last disclosure of this data for calendar year 2005; since then, Herbalife has failed to disclose its turn-over rate among non-supervisors.

As a result of these very high failure rates, Gratziani says that, in his organization alone, “realistically I’ll lose probably two-and-a-half thousand Supervisors, if not three thousand Supervisors, this year. Ya know? That’s-that’s probably the reality of it. But you wanna know something? It’s better to have three thousand than three hundred.” (Disc 1, 38:36.) Gratziani, it seems, is able to remain profitable despite these failure rates because his organization brings in such huge numbers of new recruits. Thus, Gratziani estimates that he has lost 10,000 Supervisors in the past five years, but he claims the total number of volume points generated by his organization has never been higher. (Disc 1, 39:11.) And, “you know what, the income is fantastic.” (Disc 1, 39:35.) Gratziani’s speech demonstrates that Herbalife—like all pyramid schemes—depends for its survival on the constant recruitment of new distributors. To drive the point home, Gratziani notes, “realistically, there’s probably, you know, fifty to sixty thousand distributors that I’ve been—that have—that I’ve lost over the last five years.” (Disc 1, 39:40.)

Gratziani again promises his audience “a very honest and open conversation” that will include “a level of honesty about the results . . . and the reasons why those results are the way that they are.” (Disc 1, 43:54.) He asks, “How could it be that sixty thousand people could come and go?” (Disc 1, 45:19.) And he suggests, “If we can figure out why it happened, that they came and left, do you think that we could figure out maybe how to get them to stay? Yeah.” (Disc 1, 45:46.)

He asks the audience, “These sixty thousand people, primarily, why do you think they came into the business? Primarily? Primarily?” (Disc 1, 46:05.) A few audience members call out and Gratziani agrees: “Opportunity! Money! Right?” (Disc 1, 46:15.) So much for Herbalife’s January 2013 survey that allegedly showed that 73% of former Herbalife distributors reported, in retrospect, that the primary reason they joined Herbalife was to obtain product

⁴ HLF 2005 Annual Report at 11, available at <http://ir.herbalife.com/annuals.cfm>.

discounts.⁵ As Pershing Square has pointed out in the past, this study was highly unreliable for a number of reasons.⁶ Gratziani and a room full of senior and mid-level distributors, as well as members of corporate management, know that people join Herbalife to try to make money.

Gratziani pays lip-service to the “percentage” who signed up as distributors to get a discount on the products—and he acknowledges that “we always try to make sure that they’re going to get into the business”—but he quickly refocuses on “the people that came for a business opportunity.” (Disc 1, 46:20.) He says, “the funny thing is, is, they came and they left, so definitely they didn’t have success financially in the business.” (Disc 1, 46:50.) It is disturbing how casually Gratziani talks about the tens of thousands of people who have failed in just a few years.

THE CULTURE OF HERBALIFE

As Gratziani begins to explore why 60,000 people in his downline who were trying to make money failed and quit Herbalife, he first distinguishes those failed distributors from his audience, telling them “this group specifically, there’s something specific about you,” namely “a commitment to build a business and to have a level of success with this Company.” (Disc 1, 48:43.)

He introduces the idea of “culture” (Disc 1, 49:10) and tells participants that “inside of Herbalife there’s a culture also.” (Disc 1, 50:30.) He says there is a “culture within the corporation,” and “I’m sure that if you ever had the time to talk to any of the people who are here from the home office, they could share a little bit of culturally [sic?] within Herbalife, and

⁵ Herbalife Investor Day Presentation, January 10, 2013, at Slide 43, available at http://files.shareholder.com/downloads/ABEA-48ZAJ9/0x0x627448/e3de3984-4dff-4ca3-90a1-a1c1cafeb4e/Herbalife_Investor_Day_Presentation_-_01.10.13.pdf.

⁶ *First*, the study surveyed only unsuccessful distributors, and asking an unsuccessful distributor whether he/she really ever intended to pursue the business in the first place invites significant under-reporting. *Second*, the sample size in the study was small. The Lieberman Study was based on only 100 affirmative responses, and yet it purports to draw conclusions about a nation with a population well in excess of 300 million people. *Third*, Herbalife has refused to release the survey, its questions, or its methodologies. *Fourth*, the study did not attempt to determine (a) which Herbalife products were supposedly purchased, (b) in what quantities, or (c) at what prices. *Fifth*, it is well-established that surveys of rare events return notoriously high false-positives. See, e.g., David Hemenway, Ph.D., *The Myth of Millions of Annual Self-Defense Gun Uses: A Case Study of Survey Overestimates of Rare Events*, 10:6-10 (American Statistical Association 1997) (“Using surveys to estimate rare events typically leads to overestimates.”).

so on and so forth.” (Disc 1, 50:33.) But “there’s also a very large culture within the distributor body.” (Disc 1, 50:46.)

He defines the word “culture” and then, standing at a large flipboard with a marker, he invites the audience to call out answers to the question, “what are some of the things that you know you need to do or become to make it in Herbalife?” (Disc 1, 53:09.) The audience calls out a series of slogans, many of which seem designed to pressure fledgling distributors to continue investing time and money in pursuing the Herbalife business opportunity, including:

- “Attend all the events”
- “Qualify for everything”
- “Product of the Product”
- “No problem”
- “Fake it ‘til you make it”⁷
- “Everything is unbelievable”
- “Just do more”
- “Never quit – whatever you do, never quit”
- “All you gotta do is just hang around the flagpole”
- “If it’s not working, it’s ‘cause you’re not working”
- “Attitude is everything”

Several additional slogans seem aimed at reminding distributors to focus on recruiting new distributors into the scheme rather than selling products to retail customers outside the distribution network, including:

- “Duplicate.”
- “It’s a numbers game.”
- “Some will, some won’t, so what?”

Gratziani tells his audience that these slogans are “really what we have to fall back on, and what it hides, in a certain sense, OK, is something—there’s something behind that that this is the resolution to for us.” (Disc 1, 58:45.) Then he asks a critical question:

⁷ As he writes this slogan, Gratziani turns to the audience and quips, “Some of us got so good at faking it, we forgot to make it!” (Disc 1, 54:04.) Participants burst into laughter.

If that's the answer—and those, all of those things that have become really now this attitude, the behavior, this culture that we have with being a leader in Herbalife and making it, what is it protecting us from, or, what is it covering up that's there as a reality for us?" (Disc 1, 59:22.)

THE REALITY OF HERBALIFE: "AN EVENTUAL DECEPTION"

As Gratziani begins to explore the "reality" behind the Herbalife slogans, he asks, "What do you know about your people making it in this business, as a reality for you? . . . Isn't there like a reality that you know most of your people are not going to make it? Yeah. It's like, it's a reality." (Disc 1, 59:50.)

In light of this "reality," which Des Walsh and other senior Herbalife executives deny to this day, "deception"⁸ plays a critical role in recruiting new distributors into the Herbalife scheme. As Gratziani explains:

We sell people on a dream business, that they can make it. Yet deep down inside, what do we really know? Yeah. We know that the reality is that most of them aren't going to make it. (Disc 1, 1:00:16.)

As Disc 2 begins, Gratziani is telling participants that he "never had anybody in my family join the business, because I knew how tough it was," and he "didn't want to have the responsibility of having someone come into the business, you know, because then you go back to Christmas and you're like, feel awkward." (Disc 2, 00:35.) As the audience laughs along, he describes his efforts to dissuade his own family members from signing up as Herbalife distributors. Then asks:

How many of you have had people that joined your business that were close to you—family or friends or something like that and, you know, you almost wished for a quick death for them in the business? [Laughter.] Yeah, right? (Disc 2, 1:48.)

⁸ Gratziani calls the Herbalife opportunity "an eventual deception." (Disc 2 at 7:20)

When Gratziani pauses to ask participants how they are feeling, one participant named “Toni” makes a barely audible comment to the effect that, in light of the enormous difficulty of making any money as an Herbalife distributor, she chose to recruit only a few select people rather than “playing the numbers game.” (Disc 2, 6:15.) She refers to her experience with another business and says, “I don’t want to hurt people again.” (Disc 2, 7:01.) Gratziani empathizes:

How many of you have a sense of what Toni’s talking about?
[Numerous hands go up.] Totally, like a fear of bringing people in? You know, like, a fear of—and, and, it’s funny, we wonder why our people, our downline, don’t go to their friends, to their circle of influence. Isn’t that the hardest thing that we have? A lot of it has to do with that. A lot of it has to do with that. They don’t want to—who wants to bring their family into a struggle to make it? Who wants to bring their family into an eventual deception? . . . Toni, thanks you for your honesty because that’s a very honest thing to say. And to be honest with you, I think everybody does feel that way to a certain extent.

(Disc 2, 7:20.) Gratziani thanks Toni for her honesty and says, “I think everybody does feel that way to a certain extent.” (Disc 2, 7:54.) “An eventual deception”—such candor about the reality of Herbalife is remarkable.

Another participant says, “We all on some level do this,” and “there’s always a guilt about telling people, oh it’s so easy, it’s so simple, I do it ten hours a week around my dining room table.” (Disc 2, 8:04.) Again, Gratziani empathizes:

We tell people, hey, you know, sign on the dotted line, you know, start working from home, it’s going to be unbelievable, you’re going to have this incredible life. And you know what the funny thing is, if people knew what our lives look like, like they wouldn’t sign. . . .

So there really is this situation or this level of inauthenticity that’s there. And the funny thing is, is, those people, they get it. They know that it’s there. And that’s why a lot of people say no, because they don’t buy what we’re saying, because there’s a level of inauthenticity that’s there.

(Disc 2, 8:28.) Another distributor asks a question about the “inauthenticity” of telling people they are “getting set up for freedom.” (Disc 2, 9:22.) At this point members of the audience are

shuffling anxiously in their seats and beginning to whisper among themselves. It is as if they are surprised to actually be participating in an honest conversation about the reality of the Herbalife business opportunity.

THE HERBALIFE MARKETING PLAN

Approximately twelve minutes into Disc 2 of the video, Gratziani shifts to a discussion of “how to fulfill of the marketing plan” and the difficulty of reaching particular levels. He emphasizes yet again that success depends first and foremost on recruiting:

How it happens most of the time for people is they happen to get a couple people that are committed like them, that get into the thing like them, and then all of a sudden by some magic it happens. OK? But it's not really a controlled happening most of the time. Now I'm not saying you didn't have any control in getting to the GET Team, because you did, like, you had to sign up the people, you had to, you know, give the trainings, you had to go to the meetings, you had to promote the events, you had to promote the promotions. You took action to do that. But the result that you got was based on people, what they did, and continuing on what they did.

(Disc 2, 13:20.) In giving his off-the-cuff account of what it takes to be successful as an Herbalife distributor, Gratziani says not one word about Herbalife products. As if to drive the point home, he turns around to a large pad of paper and draws a multilevel pyramid diagram, remarking that “I'm sure you're all very familiar with this.” (Disc 2, 14:15.) He says, “You know, Leslie, the 3 that get 3 that get 3, the 5 that get 5 that get 5.” (Disc 2, 14:25.)

And then, just to demolish any suggestion that Herbalife's overall business has anything to do with selling products to genuine retail customers, Gratziani declares, in no uncertain terms:

The Herbalife business model is based on distributors purchasing volume from them. OK? And that's, that's really the Herbalife business model. The Herbalife business model, at this point in time, is not based on customers purchasing, it's based on distributors purchasing volume. And we are paid, through the marketing plan, we have levels through the marketing plan, and that volume that gets purchased from the Company in our organizations, that is going to give us what our business results are.

That's, that is the Herbalife business model. That's the way that it works.

(Disc 2, 14:34.) It is difficult to imagine a clearer statement that Herbalife is a pyramid scheme. And it bears repeating that an Herbalife board member and at least three corporate executives were present (along with additional corporate staff), that the Company offered a tour for participants in this meeting, and that audience members were repeatedly assured that the Company fully supported this event.

Gratziani begins to consider various scenarios in which distributors “purchase volume,” including “distributors that qualified [as] Supervisors,” “Supervisors that bought their two-and-a-half [thousand volume points] because they had downline and they wanted to get their checks,” and “someone—there was a qualification, you know, they had done a certain amount but they purchased a little bit more because of a qualification.” (Disc 2, 16:12.) This is entirely consistent with what Pershing Square said in its December 20, 2012 presentation and elsewhere: Herbalife distributors buy volume points from the Company to climb or maintain their positions in the Herbalife pyramid and to qualify for and maximize various commissions, royalties and bonuses.⁹ The product is incidental at best.

Gratziani next tells the audience about the patterns he sees on monthly reports that Herbalife prepares for distributors who have reached the level of the Millionaire Team, thanks to Herbalife Senior Vice President Bruce Peters. (Disc 2, 17:14.) Gratziani explains:

Normally at the end of the month I have anywhere from 1.2 million to 1.5 million [volume points] in the computer, and then guess what happens in the last two days? Boom. It doubles. It doubles! So where do you think that new volume is coming from? Percentage, new Supervisors that are joining the business, very large percentage. Percentage also, existing Supervisors that are purchasing to do their two-and-a-half thousand volume points to

⁹ See Dec. 20, 2012 Presentation, Slides 159-75, available at <http://www.factsabouterherbalife.com/media/2013/01/Who-wants-to-be-a-Millionaire.pdf>; see also Declaration of Bruce A. Roth, *Herbalife International of America, Inc. v. Ford*, Case No. CV 07-2529 (C.D. Cal. May 18, 2009) (“Herbalife’s entire program is based on purchases made from Herbalife. Distributors have to purchase product from Herbalife each month in order to obtain their paychecks.”).

get whatever level, so that they can earn their, their royalties. Um, and, that's really the reality of it. (Disc 2, 17:38.)

The pattern Gratziani describes is driven by the design of Herbalife's compensation plan, which compels distributors to load inventory by month end in order to meet the plan's qualification levels, regardless of whether they have any prospect of reselling it.

Summing up, Gratziani estimates that "60% of the volume is people that are coming in. In my organization, I have about 250 Supervisors a month that are joining the organization. OK? It's a large amount of volume. It's a million volume points that's purchased just alone on people qualifying [as] Supervisors." (Disc 2, 18:32.) As Pershing Square has said repeatedly, Herbalife distributors are put under enormous pressure—both by members of their uplines and by the incentives created by Herbalife's compensation system—to order thousands of dollars-worth of product in order to qualify as a Supervisor immediately. Distributors are pressured to place these orders, without regard to retail demand, in order to qualify for recruiting rewards. Gratziani's data confirm that these Supervisor qualification orders are the lifeblood of Herbalife.

Gratziani goes on to recognize that most Supervisors fail almost immediately, telling participants, "70% of my Supervisors are doing nothing. Yeah. So it's a lot of Supervisors that came, that purchased to become Supervisors, but finally they end up not doing anything, so they're in and they're out." (Disc 2, 18:53.) This confirms that senior Herbalife distributors earn substantial sums of money from junior distributors seeking to earn recruiting rewards by becoming Supervisors.

THE ROLE OF RETAIL

Approximately twenty minutes into Disc 2, Gratziani asks the audience to consider "what type of volume would be the most ideal volume to fulfill the marketing plan with." (Disc 2, 20:20.) He recognizes that Herbalife requires Supervisors to generate 2,500 volume points each month in order to receive royalty checks, and he starts to explain that generating that volume through retail is ideal because it frees Supervisors to focus on recruiting more distributors into the scheme:

Think about this. If, if every Supervisor in your organization, at the beginning of the month, they knew by the end of the month they already have twenty-five hundred pre-sold because they have a dist—a customer base of people that are buying from them every single month, that would be like an ideal situation, wouldn't it? Would they ever have a concern for personal volume? No. It would be like, I mean, think about this. If you had your personal volume every single month done, pre-sold, what would you do during the month? You'd have choices, wouldn't you? Your choices would be, you know what, I'm going to take that twenty-five hundred and I'm going to go up to four thousand now. Or your choices would be, you know what, I'm gonna go out and find a couple of people that I can start working with to build my organization. You'd have total freedom, because that volume would already be done for you.

(Disc 2, 22:10.) In legitimate direct selling and multi-level marketing companies, recruitment efforts serve the broader goal of increasing retail activity. In Herbalife, the model is precisely opposite: the constant recruitment of new distributors is the goal, regardless of whether those distributors have any hope of earning retail profits.

Further emphasizing both the subordinate role of retail sales and the difficulty that even mid-level distributors face in trying to find legitimate retail buyers for Herbalife products, Gratziani says:

That would be the most stable business that, that, that we could ever hope for or want. Does that mean that that's what we're talking just doing that? Let's not be ridiculous. I mean, honestly. But if you did that, you would have so much time to go out and do everything that you wanted to do, to work with your people, to go recruit people, to go get more customers, to—I mean, honestly. But the thing about getting your personal volume at the end of the month would be resolved.

(Disc 2, 23:10.) Gratziani turns from his hypothetical “ideal situation” back to “the reality today,” and asks participants how many of them have 2,500 volume points pre-sold at the beginning of every month. (Disc 2, 23:40.) Only a few hands go up. Gratziani reassures them that it is extremely rare for even a mid-level distributor working full-time to be able to sell that kind of volume at retail in a month:

I don't know what the statistic would be in the Company, but if I looked at my own organization, I would say, the people that have that situation going on, I don't know, it's a percentage, maybe two [percent]. I don't think probably more than that. So, so 99% of my people don't have that going on. (Disc 2, 24:07.)

Gratziani says, "if I was at an STS," which means Success Training Seminar, a regular training event that Herbalife organizes and sponsors all over the country, mostly for prospective recruits and junior distributors, "and I asked the room, the question in the room, how many of you have ten customers that buy from you every month? I promise you that you'd have less than ten percent of the room that raises the hand. How many of you have twenty customers? I promise you have less than five percent of the room that raises the hand." (Disc 2, 26:15.) Notably, Herbalife's Rule of Distributor Conduct 18-B purportedly requires every distributor to sign a certification that he or she "personally ma[d]e sales to at least ten (10) separate retail customers in a given Volume Month."¹⁰ Here Gratziani, a senior distributor, in the presence of a board member, three executives and members of corporate staff, is admitting that fewer than ten percent of Herbalife distributors actually comply with this supposed rule.

Gratziani goes on to say that, among more senior distributors, "literally people could have sold to 200, 300, 400, 500 people, over a period of time a thousand people, and yet today, people purchasing products from them, they only have a handful. They've got 10, 20, 30, 40 people. Don't you think that's one of the reasons why it's so tough to make it in Herbalife?" (Disc 2, 26:47.) This admission belies the notion that Herbalife has a large basis of loyal retail customers.

Summing up the point about the relative unimportance of retail sales, Gratziani says, "For now, successful people in retailing in our business, it's a very small percentage." (Disc 2, 28:08.) And again: "the majority of our people have a difficulty in selling products, in general." (Disc 2, 29:46.)

¹⁰ Rule 18-B

Gratziani asks the audience why they think customer retention is so difficult, and as participants answer he echoes some of their sentiments, including:

- “We don’t listen to them [the customers].”
- “They don’t get the results they’re looking for.”
- “They’re confused.”
- “We give them unrealistic expectations.” (Disc 2, 31:51.)

WELLNESS COACHING

At this point, Gratziani pivots from his candid discussion of the reality of the Herbalife business opportunity, and begins to introduce “wellness coaching” as a new way for Herbalife distributors to build a customer base. Essentially, he explains (at length) that Herbalife distributors can get and retain more customers by pitching Herbalife products as nutritional supplements rather than as weight loss aids.

At one point in this discussion of wellness coaching, Gratziani asks Herbalife Senior Vice President Rob Levy to state the Company’s “the mission, or the mission statement.” (Disc 2, 49:11.) Levy’s response is not entirely audible, but Gratziani summarizes as, “so the vision is changing people’s lives, the mission is, like, through the best business opportunity and the best weight loss and nutrition products in the world.” (Disc 2, 49:33.) Gratziani says, “That’s the Corporation, that’s their mission,” and he recognizes that the promise of “the best business opportunity” attracts distributors, but not retail customers. (Disc 2, 49:49)

Gratziani proposes a new mission statement, “Herbalife: Bringing Health & Wellness around the World, One Person at a Time.” (Disc 2, 51:12.) He says to the audience, “if the Company’s all about that, do you question the quality of the products? Not really. Do you question the actions of the Company or the distributors? Not really. Because really what you’re up to is about something that, that, it’s just not questioned the way, yes, I’m an Herbalife distributor and I recruit and I sell and do you want to buy my products. It’s a totally different place to come from.” (Disc 2, 52:07.)

As Disc 3 begins, Gratziani is explaining what distributors can do to help reposition Herbalife as primarily a health and wellness company. He encourages the distributors—who are not required to be trained or licensed as dieticians or health

professionals—to offer free “wellness evaluations,” and he explains that “a wellness evaluation is something that we do with people that puts us into a relationship with them.” (Disc 3, 4:50.) Gratziani analogizes “wellness coaches” to doctors, chiropractors, and personal trainers. (Disc 3, 8:00.) He explains that he has “confidence” in doctors, chiropractors, and personal trainers “because of who they are,” and asks the audience:

If we are wellness coaches working with a company committed to “bringing health and wellness around the world one person at a time,” and we do wellness evaluations for people where the information that we’re giving them is not about selling products to them, but about general their health and their wellness, do you think that it creates a relationship with those people that those people can say, you know what, this is someone who knows what they’re talking about and someone I can trust?

(Disc 3, 8:40.) To be clear, Gratziani is encouraging participants in the meeting, with no training, to provide unsolicited medical and dietary advice to strangers, and to try to earn their trust as a nutrition and wellness advisor, while omitting the fact that the participants are actually interested in selling them products and even more interested in recruiting them to become an Herbalife distributor.

As he begins to conclude, Gratziani reiterates that the purpose of building a customer base through wellness coaching is ultimately to facilitate recruiting:

The one message I want to make sure you’re loud and clear on is, I’ve talked a lot about the twenty-five hundred [volume points]. You have to understand something. I’m not just interested in you and your organizations building a customer base of twenty-five hundred volume points a month. That’s not [the] final goal. But, you know what? It is something that has to happen, because—not that it has to happen, but if that happens, what does it do for the rest of our business? If every Supervisor you have comes in, and they have the tools [and] training necessary that over six months, one year, year and a half, that they can have their personal volume every month pre-sold, financially what would that mean to those people? Every month, to have twelve hundred, fifteen hundred dollars in their pocket? Would that change—would that make Herbalife truly the best opportunity in the world? And, if they could do it, do you think that they would attract people that would want to do it too? And if those people could do it too, what would that mean for building an organization? Yeah, huge. Wouldn’t

life get just so much more simple? This [pointing at personal volume requirement] is the only thing that we really have to resolve. We are already the best recruiters in the world. (Disc 3, 14:20.)

Later in Disc 3, Gratziani invites other top distributors to share their experience with wellness evaluations. Debi Katz stands first, and she tears up as she tells a story about a woman suffering from multiple sclerosis who started taking Herbalife products and supposedly called Mark Hughes to say “for the first time she was walking and doing her dishes.” (Disc 3, 18:00.) Although Des Walsh and other senior Herbalife executives have expressed shock at such unfounded health claims, they are pervasive among Herbalife distributors, as demonstrated by Katz’s willingness to make such claims in front of officers of the Company. This practice also violates the 1986 permanent injunction entered against Herbalife and its officers and representatives in an action brought by the California Attorney General and the District Attorney of Santa Cruz County. For more evidence of false product and medical claims, see the 1986 injunction itself and related videos available on www.factsaboutheralife.com.

Around 30 minutes into Disc 3, Gratziani cedes the podium to Michael Katz and another top distributor named Jody, who provides some more detail on the wellness evaluation program. Highlighting Herbalife’s support for Gratziani and his message, Katz says, “this Company has since gone over to the President’s Team reception, but, ya know, there was 8 or 10 Company people here, at their request the Company’s taping this.” (Disc 3, 32:25.) Emphasizing Herbalife’s embrace of Gratziani and his message, he tells the audience, “I just wanted to say that, from the standpoint of, if you were like, uh-oh, this or that, no. This is all Herbalife. One hundred percent Herbalife. This weekend’s Herbalife.” (Disc 3, 32:43)

Herbalife’s support for Gratziani has not wavered. Gratziani was a recipient of the Mark Hughes Bonus Award—a large, discretionary bonus paid by Herbalife to top distributors—in both 2003 and 2008.¹¹ He reached the Chairman’s Club in 2010,¹² and he

¹¹ See Exhibits 2 and 3, respectively.

¹² See Exhibit 1.

appeared as a featured speaker at an Extravaganza organized by the Company as recently as 2012.¹³

ADDITIONAL POINTS

A few additional points bear mention. *First*, the video corroborates that Herbalife’s various levels of distributors, its complex commission structure, and its various qualification and requalification requirements are designed to keep distributors investing time and money in pursuing the Herbalife business opportunity. *Second*, Gratziani’s account of his own rise through the ranks at Herbalife exemplifies a recruiting tactic in which top distributors purport to empathize with mid-level and junior distributors who are losing money, but at the same time tell them that many people are able to rise to top levels of the pyramid in an unrealistically short period of time. *Third*, some of Gratziani’s comments epitomize the patronizing way in which Herbalife speaks to and about the Latino community.

Complex Commission Structure

In 2013, the Securities and Exchange Commission issued an investor alert “warning investors about the dangers of potential investment scams involving pyramid schemes posing as multi-level marketing programs.” One of the “hallmarks of a pyramid scheme” set forth in this investor alert is a “[c]omplex commission structure.”¹⁴

The Herbalife Sales and Marketing Plan is a very complicated, long document that would be unintelligible to the average consumer. The document spans 126 pages and contains more than 150 rules, and those rules are frequently revised and supplemented in notices to distributors. The Herbalife distribution network itself has eleven levels of distributors. The manner in which distributors at these various levels are compensated is complex and opaque, especially for recruits who are not experienced in business and not economically sophisticated. Distributors at the level of Supervisor and above can be eligible to receive at least five different forms of payments from Herbalife, including Wholesale Commissions, Royalty Overrides, Royalty Override Roll-ups, Production Bonuses and the Mark Hughes Bonus. The various

¹³ http://www.herbalifeextravaganza.com/2012/panama/pdf/es/stephan_gratziani_EXT_2012_V2.pdf.

¹⁴ http://www.sec.gov/investor/alerts/ia_pyramid.htm.

qualification and requalification requirements for each level and for each type of compensation are also highly complicated.

Early in the video, as Gratziani describes his own rise through the various levels in the Herbalife compensation system, he describes the incentives that each new level creates:

That's kind of another interesting thing. You know, we have all these commitments. How many of you are on the World Team right now? Like, how many of you want the GET Team so bad you can taste it? You know what I mean? It's like, ugh! You know? It-it-it-it consumes like a major part of you.

(Disc 1, 21:55.) Gratziani's comments confirm that the qualification and requalification requirements at each level put constant pressure on mid-level distributors to invest ever-larger amounts of time and money in their efforts to climb the Herbalife pyramid.

The Speed with Which Some (Supposedly) Can Rise to the Top

Gratziani claims that he qualified for the Millionaire Team in three years and the President's Team three years after that. (Disc 1, 24:30.) If true, these are impressive numbers—Herbalife's revised Statement of Average Gross Compensation discloses that in 2013, only “53 U.S. Members achieved the level of President's Team. They averaged nine years as an Herbalife Member before reaching President's Team, with the longest duration being 31 years and the shortest being less than three years.”¹⁵ But, in a room full of mid-level distributors who are driven by the promise of riches if they qualify for higher levels like the President's Team, Gratziani tries to create a sense of inevitability, telling his audience that, “at the time, with everything that was going on, and the new markets that were opening, six years to the President's Team was a very long time. You know, people were doing it in 11 months, and people were doing it in a couple of years.” (Disc 1, 24:47.) Perhaps it is possible to reach the President's Team in less than a year in the “pop” that occurs when Herbalife enters a new market, but it is not possible in established (*i.e.*, saturated) markets like the United States.

¹⁵ <http://www.herbalife.com/content/en-us/pdf/business-opportunity/statement-of-average-gross-compensation-usen.pdf>. Gratziani also states that it took another three years to receive a President's Team check, for a total of nine years.

The Latino Community

Numerous advocacy groups and public interest organizations have accused Herbalife of targeting vulnerable populations, including the urban Latino community in the United States.¹⁶ The Company's response has been insensitive and patronizing at best. Indeed, in October 2013, Herbalife CEO Michael Johnson showed up at a press conference organized by League of United Latin American Citizens ("LULAC") and other groups and reportedly began yelling at LULAC members.¹⁷ Gratziani's comments exemplify the condescension with which Herbalife speaks to the Latino community:

Everybody's well aware that we have a very fast-growing Latin part of our business in Herbalife here. It's almost impossible [not] to notice, you know, they're going to be next door and they're going to be making so much noise during the weekend. You know, it's almost [im]possible. So. And I love it, because they say, well, it's normal, you know, because the Latin people, they're just so warm-hearted. They just talk to everybody and, you know, they're so family-orientated that if someone in the family has it and it's good for them, they want to share it with all the family. You know, we have people from Puerto Rico that are here. Compassion, you know. But culturally, you know, we kind of say, that's the way it is culturally. (Disc 1, 49:40.)

CONCLUSION

When speaking candidly, top distributors admit the reality about Herbalife's bogus opportunity: distributors enroll primarily to earn money and then fail – overwhelmingly, inevitably, and predictably. Retail sales are virtually nil. Sales leaders face a life of struggle, pretending they are doing well, then leaving disappointed. Those who stay get “so good at faking it, we forgot to make it.” Promoting “this incredible life,” senior distributors admit “a

¹⁶ <http://latino.foxnews.com/latino/money/2013/10/18/latinos-urge-california-to-investigate-herbalife-as-pyramid-scheme/>

¹⁷ <http://www.businessinsider.com/michael-johnson-yells-at-hlf-protesters-2013-10>.

level of inauthenticity.” They find it difficult to recruit friends and family “into an eventual deception.”

This reality, as admitted by top distributors in the presence of senior Herbalife executives, staff and a board member, confirms Pershing Square and other critics’ assertions about Herbalife and belie the Company’s empty defenses—Herbalife is a pyramid scheme.