The fine line between legitimate businesses and pyramid schemes

Companies say sellers can make six-figure salaries; critics call multilevel marketing firms a scam

Pablo Caicedo, of Chicago, became a distributor of Herbalife after losing 35 pounds using the product. He says he earned enough money selling Herbalife to quit his job as a parking valet. (Armando L. Sanchez, Chicago Tribune / February 6, 2013)

By Gregory Karp, Chicago Tribune reporter

February 10, 2013

Controversy is again casting a shadow over the multilevel marketing industry, as nutritional supplement company Herbalife Inc., which has thousands of distributors in the Chicago region, has been publicly called a pyramid scheme by a prominent investor — an allegation the company vigorously denies.

Meanwhile, a different multilevel marketer, Fortune Hi-Tech Marketing, was shut down in recent weeks after a lawsuit was brought by regulators and several states, including Illinois, alleging the company scammed consumers out of $169 million. The scheme affected an estimated 100,000 Americans, including some in Chicago, where it targeted Spanish-speaking consumers, the Federal Trade Commission alleged.

Most people outside the industry might have only a vague notion about multilevel marketing, also called network marketing and direct selling. It often involves personal sales of cosmetics, wellness products or home decor items — or as critics flippantly call it, "pills, potions and lotions" — usually sold through product parties hosted by friends or relatives.

For sellers, the companies offer the appeal of starting a business on the cheap with little training, working from home and being their own boss, if only for part-time money. Some might recruit friends and family to become sellers, which augments their own commissions and gives them a shot at the six-figure compensation many such marketing companies tout but few distributors attain.

The largest multilevel marketing companies, often known as MLMs, are household names: Avon, Mary Kay, Pampered Chef and Amway. MLMs have annual sales of about $30 billion, with about 16 million people in the United States selling their products, according to the industry group Direct Selling Association, which represents these firms and others.

The recent controversies might raise the question: What's the difference between a legitimate multilevel marketing company and an illegal pyramid scheme, in which only people who get in first — at the top of the pyramid-like structure — make money and everyone else is a dupe?

The harshest critics maintain there is no difference, that there's no such thing as a legitimate MLM and that the industry's secrets stay safe because of a cultlike mentality and a blind eye of regulators.

Jon M. Taylor, who was once a seller for an MLM company, said he has studied the industry for 18 years and analyzed more than 500 MLM companies. He maintains the website MLM-thetruth.com and offers a free e-book there.

"I have not yet found a good MLM — a good MLM is an oxymoron," Taylor said.

He said all MLM companies have the same flaw: They depend on endless chains of recruiting new members. "There is no more unfair and deceptive practice than multilevel marketing," Taylor said.

Tracy Coenen, a forensic accountant and fraud investigator with Sequence Inc. in Chicago and Milwaukee, is author of the Fraud Files Blog. She is also a critic.

"Multilevel marketing companies are pyramid schemes that the government allows to operate," said Coenen. "The only difference is that Herbalife, or any multilevel marketing company, has a tangible product that they use to make their pyramid appear legitimate."

The Direct Selling Association says MLMs are legitimate businesses, and that the group has about 200 members carefully screened by the organization to ensure they are not pyramid schemes and don't use deceptive practices.

The Federal Trade Commission agrees there are legitimate MLMs. The difference between a legitimate business and pyramid scheme comes down to products.

If the company and its distributors make money primarily from the sale of products to end-users (and not boxes of product accumulating in a distributor's garage), it's OK.

By contrast, a pyramid scheme compensates those at the top of the pyramid with participation fees paid by those recruited at the bottom. It eventually collapses when the scheme can't recruit more people.

But identifying a pyramid scheme can be difficult because MLMs typically have product sales, along with recruitment fees and recruitment incentives.

"It gets cloudy when you have a situation where you have fees being paid for both," said Monica Vaca, assistant director of the FTC's division of marketing practices. "It's very nuanced."

While prosecuting an MLM can seem somewhat of a judgment call, cases have a common factor: deceptive promises about how much money distributors will earn, Vaca said.

In the Fortune Hi-Tech Marketing case filed last month, C. Steven Baker, director of the FTC's Midwest region, said, "These defendants were promising people that if they worked hard they could make lots of money. But it was a rigged game, and the vast majority of people lost money."

Joe Mariano, president of the Direct Selling Association, said MLM companies typically use multilevel compensation as an alternative to traditional advertising. Companies use money they would otherwise spend on ads or shelf space to instead pay distributors.

"Pyramids are bad guys," Mariano said. "Their mere existence confuses the marketplace and makes it more difficult for legitimate direct-selling companies to do business and to be understood."

Key to the association's code of ethics, which members are expected to abide by, is a prohibition on deceptive sales practices, including promises of outsize earnings. Fortune Hi-Tech was not a member of the association, Mariano said.

Indeed, it's often true that the vast majority of distributors don't earn near enough to make MLM selling their primary job. The Direct Selling Association puts median earnings at $2,400 per year, although critics say the vast majority earn nothing.

Still, Mariano is quick to point out: "Somebody who works hard at this has the potential to do very, very well."

Los Angeles-based Herbalife, a 32-year-old seller of weight-loss shakes and wellness products, became news in December when Bill Ackman, founder of Pershing Square Capital Management, made a $1 billion bet against Herbalife by shorting the stock. He has repeatedly called the company a pyramid scheme and gave a lengthy and public explanation of why.

(Ackman's Dec. 20 presentation is available at factsaboutherbalife.com while Herbalife's Jan. 10 response is available at its website for investors, ir.herbalife.com

In the Chicago area, Herbalife has a huge presence, with more than 16,000 distributors in the metropolitan region, about a quarter of whom are avid sellers or "leaders," according to the company.

In an interview, Herbalife President Des Walsh said the company is not a pyramid scheme because it sells "real products to real people" and doesn't directly pay for recruiting new distributors. He points to the company being in existence for three decades, operating in 88 countries and continuing to grow. "That growth has been based on more customers consuming our products every single day around the world," he said.

He said Ackman is "seeking to disseminate false and misleading information" about Herbalife to lower the stock price and profit from his bet against the company.

Beneath the fray of high-finance skirmishes is Pablo Caicedo, 38, of Chicago, and his story is typical.

He said he started using Herbalife products, lost 35 pounds and felt like he had more energy. He learned he could get a discount on the products he used by becoming an Herbalife distributor, which he did. He began selling to friends as well. After three months, he was making enough money to quit his job as a parking valet, he said. And for 14 years since, he's sold Herbalife products.

He said the negative publicity around MLMs and Herbalife, in particular, doesn't bother him, chalking it up to other people's opinions. "There are always two sides to an issue," Caicedo said, adding that he has been satisfied with Herbalife. Caicedo said he wasn't comfortable disclosing how much money he earns annually from Herbalife sales.

However successful Caicedo is financially with Herbalife, others aren't nearly so.

In fact, 88 percent of Herbalife distributors earned no commissions in 2012, according to company numbers. That excludes potential profits distributors might have earned on sales of products to others, but it also excludes sales expenses distributors incur, figures Herbalife says it doesn't have.

Why do so few make money?

Herbalife says it's because 73 percent of its sales force only join as distributors to get a wholesale discount on products that they use themselves. For those people, paying the $59 or $109 to become Herbalife distributors, depending on the starter kit, is like paying a fee to join a Costco warehouse club to get better prices, Walsh said. The product discount for those distributors is 25 percent.

But even the vast majority of those who are sales "leaders" at Herbalife, the top 20 percent of sellers, don't earn enough to live. Last year, more than half of the 82,464 sales leaders earned $1,000 or less in commissions for the whole year, according to Herbalife.

Walsh said that's because most of them make Herbalife a part-time business, viewing profits as incremental income, perhaps to pay for a family vacation. "It's an additional form of part-time income that really can help significantly impact their lives," he said.

However, like all MLMs, the very top sales people can profit handsomely. Of those who achieved the sales status of "leader," 0.7 percent make six-figure dollar amounts in commissions. And 194 distributors, 0.2 percent of leaders, had average gross payments from Herbalife of $724,030.

Such earnings disparity is common in multilevel marketing.

Often MLMs will suggest the difference in earnings stems from a difference in effort, that some sellers are more serious about the business than others.

However, critics say high earners are part of a deception and contribute to the lottery mindset of sellers.

Herbalife isn't the only company in the news.

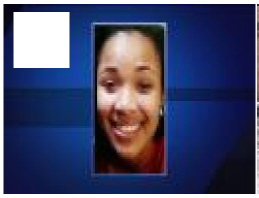
On Jan. 28, the suit by the FTC and several state attorneys general shut down Fortune Hi-Tech Marketing, a network marketer whose distributors sold products that included health and beauty goods and those from certain wireless providers.

The company's distributors earned little for selling goods and services and made more signing up additional sales people, regulators allege. Most paid $100 to $300 in annual fees, and some paid additional money to be eligible for sales commissions and recruiting bonuses.

Fortune officials could not be reached for comment.

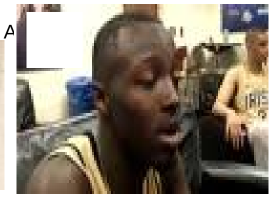
At a news conference in Lexington, Ky., the FTC's Baker reportedly declined to comment on whether the move against Fortune Hi-Tech means the agency is making a more aggressive push against direct marketers.

gkarp@tribune.com



Funeral for Hadiya Pendleton held Saturday

Supporters gather outside Pendleton funeral



Notre Dame's Jerian Grant on epic rally against Louisville

The Tribune is using Facebook comments on stories. To post a comment, log into Facebook and then add your comment. To report spam or abuse, click the "X" in the upper right corner of the comment box. In certain circumstances, we will take down entire comment boards. Our commenting guidelines can be found here ».

Add a comment...

Comment

Facebook social plugin