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A Short Seller Takes on a Vitamin Vendor

A hedge fund claims that Herbalife is a pyramid scheme—and bets that it will come crashing down.

By RICH KARLGAARD

When does a so-called multilevel marketing company go to the dark side and become a pyramid scheme?

That's the question aimed at [Herbalife](#), the Los Angeles-based maker of vitamins and weight-loss pills. A month ago Herbalife was in apparent robust health. Annual sales were on track to soar past \$4 billion, and its stock was sailing smoothly in the mid-40s. Herbalife's market cap was a nontrivial \$6 billion, ranking it with companies like [Southwest Airlines](#) and [BMC Software](#).

Then a Grinch showed up and stole any Christmas glow the company might have enjoyed. On Dec. 20, hedge-fund manager Bill Ackman, CEO of Pershing Square Capital, tore apart Herbalife in a three-hour, 300-slide presentation to 500 investors in New York. Mr. Ackman called Herbalife a "modern day version of a Ponzi scheme" and a serial liar about its sales figures. He vowed to short Herbalife into the dirt.

Mr. Ackman hasn't stopped there. He created a website—factsabouth Herbalife.com—and placed negative ads on [Google](#). Herbalife, led by a feisty triathlete named Michael O. Johnson, countered immediately. The company hired [David Boies](#), the lawyer who prosecuted [Microsoft](#) on behalf of the U.S. Justice Department and once defended [George Steinbrenner](#) against Major League Baseball. The short seller versus the vitamin vendor promises to be a bloody and entertaining fight if you like this sort of thing.

But should we like this sort of thing?

In one of Garrison Keillor's "Prairie Home Companion" radio tales, he talks about the small-town residents of fictional Lake Wobegon going to a cow-pie tossing contest during the dog days of summer. The cow-pie idea seemed funny to all concerned, but the actual contest was a wretched business. Returning to their homes, the innocent rubes of Lake Wobegon felt embarrassed that they had gone at all. They kept their eyes to the ground. Nobody talked to anyone.

The Ackman-Herbalife clash is a cow-pie contest. It is being held during the dog days of capitalism, these sad years of 2% annual growth or less. Both actors claim to be knights protecting the honor of capitalism and free markets. In fact, both actors exploit capitalism's noble purpose.

Let's start with Herbalife. It sells products that promise health and vitality with little scientific basis behind the claims. Nothing really wrong with that—many of us take vitamins on faith that they might work. No harm is done, and maybe some good.

But Herbalife also uses a selling and distribution network called multilevel marketing. Here is where things get sticky. Herbalife's sales force consists of a network of independent direct-sellers. The sellers are compensated in two ways. One is by selling Herbalife's products. The other is by recruiting new sellers and taking a percentage of their action. For example, the Herbalife seller who recruits 10 new sales people who each, in turn, recruit 10 of their own, will get income from 110 so-called down-line sellers. It pays to get in early.

If this sounds to you like a pyramid scheme, the Commercial Court of Brussels agrees. But the Federal Trade Commission and various U.S. state regulators aren't so sure. The line between a legal, if dodgy, multilevel-marketing firm and an illegal pyramid scheme hinges on many factors:

Are sellers compensated primarily by commissions from the products or the recruitment? The latter is a warning flag.

Is the company open and transparent about its compensation schemes? Does it tell new recruits how many layers of sellers exist above them?

Does the company inflate its revenue by forcing its independent sellers to buy more products than they can sell?

Those are the hard signals. Some soft signals also warn of a pyramid:

Does the company run a lot of advertising—radio is the preferred medium—promising wealth and independence while saying little about what the company actually does?

Do the brochures and websites show the company's products or do they feature photos of handsome couples enjoying luxurious lives with expensive homes, cars and jets?

Is the company CEO worshiped as a hero of capitalism within the company?

Is the language used at company meetings informational or cultish? Is dissent and argument encouraged (as is true at healthy companies) or suppressed?

Mr. Ackman claims that Herbalife is a pyramid. He says only 0.14% of Herbalife's sellers make more than \$20,000 per year and that 93% make no commissions at all—the bottom of the pyramid. At the top of Herbalife's compensation pyramid are those who make nearly all their commissions from recruitment and very little by selling product.

The hedge-fund manager's initial blast against Herbalife took the stock down 40%. Herbalife has since gained 24% back—but a stock that falls 40% must rise 67% to get back to even. So Herbalife is still in the hole. Mr. Ackman is so far winning.

But it's hard to root for Bill Ackman. Cheering for a short seller goes against the American spirit, even if short sellers can usefully warn investors of frauds and hype. Warren Buffett,

for one, refuses to short stocks at all. He says he wants to avoid the unlimited losses of a short sale gone bad. But I suspect that Mr. Buffett has another reason. He knows that betting against success would hurt his apple-pie image.

So Ackman vs. Herbalife has no heroes. Both parties, in their own way, take advantage of the goodwill and trust that underlie capitalism. Herbalife recruits sales people with the knowledge—based on mathematical certainty but undisclosed to its recruits—that the vast majority will lose money. Mr. Ackman, for his part, has gotten rich betting against bad companies. One party is possibly immoral, the other party at best amoral. Who do you cheer for?

Better to root for America to double its economic growth and start building real companies again. And to root for an economy in which entrepreneurs and sales people can get rich honestly and investors and lawyers are willing to help them all the way.

Mr. Karlgaard is the publisher of Forbes.

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