Nu Skin Faces Pyramid-Scheme Allegations in China

INTRODUCTION

Nu Skin Enterprises, Inc. has come far in its nearly 30-year history. Founded in Provo, Utah, in the United States, the company is based upon a multilevel marketing direct-selling model that employs independent contractors to sell personal care products and dietary supplements. The firm has gone on to become the seventh largest direct seller in the world, with 2013 revenue of over $4 billion. It has paid out more than $10 billion in commissions and sales incentives. Nu Skin has been recognized throughout the years for its innovative products and social responsibility initiatives, but it has also faced some ethical and legal challenges.

Today Nu Skin has a widespread global reach, operating in 53 international markets on five continents. In particular, China has become a lucrative market for Nu Skin's direct-selling operations. Nu Skin's Chinese sales force consists of more than 400,000 sales representatives and sales in China account for approximately 30 percent of Nu Skin's revenue. Nu Skin has performed so well in China and other countries that CEO M. Truman Hunt has announced the company's intention to increase its revenues to $10 billion by 2020. China is a critical market for reaching this goal.

Despite Nu Skin's rapid growth and success, allegations arose in China that could prove challenging to the company's sales objectives in that country. Chinese newspapers accused Nu Skin sales representatives of operating an illegal pyramid scheme in China, an accusation that Nu Skin vehemently denied. Both Nu Skin and Chinese investigators looked into the company's selling practices to determine if misconduct had occurred.

This case will examine the challenges Nu Skin has recently faced in China. It starts with a brief history of Nu Skin, followed by information on its social responsibility initiatives. We then discuss ethical challenges the company has faced in the past. Next, we consider the allegations that have arisen against Nu Skin in China as well as Nu Skin's reaction to these allegations. The case also examines the result of the investigation in China.

BACKGROUND OF NU SKIN

Nu Skin Enterprises, Inc. was founded by entrepreneurs Blake Roney, Steve Lund, Sandie Tillotson, and Nedra Roney in 1984. Brother-and-sister team Blake and Nedra Roney decided to adopt a line of skin-care products that possessed no fillers and only contained ingredients that were good for the body. The founders adopted the principle "all of the good, none of the bad" to guide the company. The mission statement of Nu Skin includes the following: "Our mission is to be a force for good throughout the world by empowering people to improve lives with rewarding business opportunities, innovative products, and an enriching, uplifting culture." The founders decided to adopt a multilevel marketing (MLM) compensation model, which allowed them to stay out of debt. A multilevel marketing compensation model is when independent contractors have the opportunity not only to earn commissions on the sales of their products but also commissions from products

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that their recruits sell. This model rewards independent contractors for recruiting other independent contractors to distribute the product, but the model itself is completely based upon whether a product is being sold.

By 1989 the firm was experiencing massive growth. It opened its first operations in Asia two years later. In 1996 the firm released its initial public offering and become a publicly-traded organization. That same year it acquired the dietary supplement company Pharmanex and began offering products under the Nu Skin and Pharmanex brand names. The company's biggest seller became LifePak, a dietary supplement which Nu Skin markets as being able to help the body achieve an ideal level of antioxidants, vitamins, and minerals. The product currently makes up 15 percent of the company's sales. The firm has also invested in technological innovations to help maintain health and fight against aging. For instance, its BioPhotonic Scanner is a technology that Nu Skin patented with the purpose to measure carotenoid levels in the skin. These levels help indicate a person's antioxidant levels, which assists consumers in making more informed health choices.

In 2009 Nu Skin entered into an agreement with genomics company LifeGen Technologies to investigate "gene expression filing" and its impact on aging. This collaboration resulted in a number of new anti-aging products, including the ageLOC® R2 nutritional supplement. Nu Skin claims that its AgeLOC products help reduce and reverse the effects of aging. In 2011 Nu Skin acquired LifeGen Technologies for $11.7 million, allowing it access to LifeGen's proprietary research and technologies. Nu Skin has extensively promoted its anti-aging products, with the company's chief scientific officer calling their products "a fountain of youth." Today the marketing team works closely with in-house scientists to develop new product innovations in this area.

Nu Skin's independent distribution network is critical to its success. To become a Nu Skin independent contractor, applicants must have a current independent contractor to sponsor them. Those who do not have a sponsoring independent contractor in the area are encouraged to call Nu Skin's toll-free number for a sponsor. Once an applicant has a sponsoring independent contractor ID, he or she can sign up online through Nu Skin's website or by phone. The new independent contractor signs up with an Automatic Delivery Rewards program (ADR) where products are delivered at the end of each month. Nu Skin recommends that active independent contractors purchase a minimum of $100 per delivery of products to maintain their active status. Independent contractors also have the option of purchasing one of Nu Skin's sponsoring packages, consisting of different products in a product line helpful for jumpstarting their business. Independent contractors can receive additional compensation through the recruitment of others by earning a commission of the sales from those they recruited. Nu Skin offers a 5 percent commission on the sales of an independent contractor's direct recruits only. When the independent contractor achieves a certain amount of personal and group sales volume (from their group network consisting of recruits) combined, he or she can become an executive leader. Executive leaders can then earn nine to 15 percent (depending on combined volume sold) in commissions from the sales of both direct and indirect recruits, allowing them to earn executive bonuses based upon product purchases within the group. Some entrepreneurs have become highly successful as Nu Skin independent contractors, and Nu Skin promotes itself as a legitimate entrepreneurial opportunity. The firm claims that 43 percent of its product revenue is paid out in compensating independent contractors who are operating their own independent businesses.

Some may consider this percentage to be high, but the average markup for cosmetics is estimated to be 78 percent. There are little to no overhead costs in direct selling as there are in brick and mortar

stores, so the markup on Nu Skin products is allocated for commissions. Further, independent contractors are not considered as employees but as owners of their own businesses. Independent contractors enter into an agreement with the direct selling agency to purchase and distribute the products. However, the amount of product sold and the length of the agreement depends upon the needs and desires of the independent contractor. People enter into these agreements for various reasons. Some want to make direct selling a full-time job, so the amount of effort they spend in marketing and recruiting their business is significant. Others will become independent contractors in order to make some extra spending money, so the effort they expend is minimal and may be short term. In either of these cases, direct selling offers entrepreneurs a great opportunity while reducing much of the risk associated with starting a new business. Finally, there are those who will sign up simply to receive the independent contractor discount on personal purchases rather than to take advantage of a business opportunity.

Nu Skin products are split fairly evenly between nutritional and personal care items. Interest in anti-aging products has grown as well; skincare and nutrition product lines that are marketed as anti-aging have strong revenues. Nu Skin practices a product development process in which distributors can learn about new products a year before their launch. This familiarizes them with the product and prepares them for selling it.

Under the leadership of CEO M. Truman Hunt, Nu Skin has achieved widespread growth. This has been especially noticeable because, for many years, Nu Skin shares traded beneath their IPO price. Within a three-year period with Hunt at the helm, Nu Skin's stock price rose 500 percent. In 2012 Hunt was recognized as CEO of the year by *Utah Business* magazine. In 2014 Hunt received the *Direct Selling* Bravo Leadership Award and was elected Chairman of the U.S. Direct Selling Association. Nu Skin continues to maintain an A+ rating with the Better Business Bureau, implying that Nu Skin conducts business ethically and handles complaints in a timely manner.

Much of Nu Skin's recent success can be attributed to sales in China. Within a three-month period, sales of products for the Greater China unit tripled. Due to laws prohibiting multilevel marketing in China, Nu Skin has had to run its operations differently than in the United States. Direct selling companies are required to sign a contract saying they will not employ the multilevel marketing aspect of direct selling in order to conduct business. As a substitute for recruiting, independent contractors sell their products from retail stores, thus eliminating commissions from the sales of recruits.

SOCIAL RESPONSIBILITY

Nu Skin believes it is important to give back to its community. The company adopted a for-profit initiative called Nourish the Children, which provides a unique social entrepreneurship opportunity for independent contractors. They can purchase VitaMeal®, a nutritious food supplement, and donate it to charities that in turn donate them to children in need. Independent contractors can earn commissions from these purchases, and Nu Skin itself donates one bag of VitaMeal for every eight bags purchased. Each VitaMeal package is equivalent to 30-child sized meals, and is produced locally to provide jobs for local populations. Millions of children have been the beneficiaries of this initiative, with approximately one child receiving a serving of VitaMeal somewhere in the world every second. Since 2002, 340 million meals have been provided through the program. In 2011 Nu Skin won the Bravo Humanitarian Award from *Direct Selling News* for making such a positive difference.

The company also established the Nu Skin Force for Good Foundation in 1996 to create a positive impact in global communities. The nonprofit Nu Skin Force for Good Foundation has embarked on many projects to help communities in different parts of the globe. For instance, Nu Skin partnered with other nonprofits to build a village in Malawi that would act as a "living classroom" to teach farmers and their families new agricultural skills to help them withstand drought and benefit economically. Nu Skin also donates twenty-five cents from sales of its Epoch Baobab Body Butter product to fund the Malawi Hope for Seeds project. The money is used to purchase seeds for growing trees. Due to deforestation, many in Malawi suffer from poverty, and the quality of the soil for farmers has been depleted. By planting trees such as fruit trees that can be harvested later, villagers receive a source of income and the soil is enriched by the growing trees.

To celebrate its 30th anniversary, Nu Skin held a gala at a sales convention to raise $2.2 million for its foundation. Its annual Force for Good day was celebrated by contributing children's books and school supplies to local schools in disadvantaged areas. For the entire month of June, 2014, Nu Skin distributors engaged in community services to celebrate the anniversary. This included raising funds for children in Southeast Asia who needed heart surgeries and raising money for orphanages.

In addition to its more global initiatives, the Force for Good Foundation also encourages independent contractors to volunteer in their local communities. Nu Skin headquarters sponsor a Force for Good Day where employees donate beneficial kits to their community. Nu Skin employees also donate to the Provo Food & Care Coalition to provide meals for those in need. Additionally, employees and independent contractors donate time or money for the United Way Day for Caring and the Children with Cancer Christmas Foundation. In the area of sustainability, Nu Skin has developed a recycling program where independent contractors can return empty Nu Skin glass jars and bottles and receive one ADR point. Finally, Nu Skin acts as a sponsor for the Brigham Young football team and America's Freedom Festival. In 2010 Nu Skin was named among *Forbes*' "Most Trustworthy Companies."

NU SKIN FACES CHALLENGES

Despite the positive impact Nu Skin has had on communities, it has received criticism for questionable conduct in the past. The first sign of trouble came in 1991 on *Nightline*, the investigative journalism television show, when Nu Skin was accused of being a pyramid scheme. Allegations of pyramid schemes against MLM companies are not uncommon because much of the general populace does not understand the difference between the two. Pyramid schemes are scams where an investment or product of limited or no value is offered. These fraudulent schemes depend almost exclusively on recruitment. New recruits pay a fee to join the "opportunity" to sell or invest, but rather than selling products or investments they earn money by recruiting others into the scheme. Eventually, pyramid schemes implode when the stream of new recruits dries up. Those at the top of the pyramid earn money off commissions from recruiting others, while those at the bottom (the newer recruits) lose out.

Because Nu Skin does pay commissions to independent contractors based upon the sales of their recruits, many people mistake their compensation system as a pyramid scheme. However, an MLM compensation system differs from a pyramid scheme in two ways: a product or investment opportunity with actual market value is being sold, and independent contractors do not get paid commissions based simply on recruiting. Rather, they receive commissions on the sales of their recruits. In other words, products must be sold to receive compensation.

Another characteristic that characterizes pyramid schemes is inventory loading. This occurs when a company encourages independent contractors to make large scale purchases, increasing the risk that the independent contractor will be stuck with inventory that they cannot sell or do not want to use. However, direct selling companies differentiate themselves from pyramid schemes by having a buy back policy that reduces or eliminates this risk for the independent contractor. Nu Skin's buy back policy states they will buy back unused resalable inventory from an independent contractor for up to 90 percent of the price they paid plus tax. This is after a 10 percent deduction for administrative fees, and the return must be made within 12 months of the original purchase date. Although the *Nightline* episode was damaging to Nu Skin, many other MLM companies have been accused of similar wrongdoing due to confusion over the difference between an illegal pyramid scheme and an MLM compensation system.

Nu Skin's reputation suffered again when it was accused of deceptive advertising. In 1992 the company settled charges from five states that alleged Nu Skin was engaging in deceptive advertising and recruiting. Two years later the Federal Trade Commission (FTC) accused Nu Skin of making deceptive claims regarding products and recruitment. For instance, Nu Skin advertisements seemed to imply that independent contractors should be earning at least $10,000 a month, but the FTC thought this was misleading because only a few independent contractors earned that much a month. Nu Skin paid $1.3 million to settle the allegations. In 1997 the FTC again accused Nu Skin of making unsubstantiated product claims not backed up by evidence. Nu Skin paid $1.5 million to settle the allegations and lost many independent contractors as a result.

Another criticism levied against Nu Skin involved the selling practices of its technology division QIQ Connections during the 1990s. In 1998 Pennsylvania's Attorney General's office sued the firm, alleging that QIQ was a pyramid scheme. According to allegations, investors who wanted to become independent contractors paid $289.60 to join and earned $50 dollars for each new recruit signed up. However, products that they were supposedly selling (including Internet access, pager service, and cell phone service) did not exist. Nu Skin responded by discontinuing QIQ and admitted that some of its independent contractors had become "overzealous" in their marketing. Nu Skin allowed the independent contractors to transition to another Internet MLM company Big Planet, of which Nu Skin held a majority interest. Big Planet was criticized for recruiting independent contractors who did not have good knowledge of the products they were selling.

The personal lives of some of the founders of Nu Skin have also been called into question. Nedra Roney left the firm years ago, but her colorful lifestyle—including being convicted of pharmaceutical and insurance fraud in 1996—brought both her name and Nu Skin into the headlines. Two of co-founder Sandie Tillotson's ex-husbands have written negative memoirs of her. Tillotson stepped down from Nu Skin's board but remains senior vice president. She has sued her ex-husband, claiming that his negative information has had a detrimental impact. One of her exhusbands has bet against Nu Skin's stock, which could raise questions of the motivations behind his memoirs.

Probably the biggest issue that plagues Nu Skin is allegations that the majority of independent contractors lose their investments. Critics claim that the only way independent contractors can profit from selling Nu Skin is if they recruit others. These allegations are not limited to Nu Skin; most direct selling firms have received similar allegations. Supporters of Nu Skin and other direct sellers claim that direct selling takes work and a certain amount of skill. Not everyone is cut out for direct selling. Additionally, many people choose to engage in direct selling as a part-time job to earn

extra income, and some become independent contractors to receive product discounts from the company. Hence, while these allegations should be investigated for their validity, they may not take into account independent contractors who only sell part-time or who are not adept at direct selling. While many independent contractors fail, there is a high failure rate in all small businesses. It is important to remember that each independent contractor is operating as a sole proprietorship.

CHINA ALLEGATIONS

With so many of its sales coming from China, it is inevitable that ethical issues will arise for Nu Skin. Because Nu Skin relies on independent contractors, it can be hard to monitor all of its sales force. For instance, one video posted on a Chinese website claimed that Nu Skin products would help cure cancer. Nu Skin took action against the independent contractor and removed the video. One Nu Skin short-seller has claimed that undercover Chinese customers informed him that Chinese independent contractors are promoting pyramid-like schemes. However, because short-sellers benefit if the price of the stock goes down, it is not clear how objective his claims might be. Citron Research also published a report in 2012 stating that Nu Skin was engaging in illegal multilevel marketing in China.

A more recent accusation is the claim that independent contractors are operating a pyramid scheme. On January 15, 2014, the *People's Daily* newspaper—the official Communist newspaper in China—suggested that Nu Skin was running an illegal pyramid scheme. Specifically, reporters claimed that Nu Skin had been lying about its business in China. They accused the company of passing off advertisements as news reports and exaggerating their creditworthiness and influence within the country. The reporters also claimed that Nu Skin brainwashed its direct sellers in China, encouraging them to sell more products than allowed. A day later China's State Administration for Industry and Commerce announced it was launching a probe into Nu Skin's operations. That same day *People's Daily* released another report stating that Nu Skin direct sellers were engaging in multilevel marketing.

Accusations of pyramid schemes are especially serious in China. The government has traditionally held a negative view of direct selling companies. For some time direct sellers were not allowed to operate in the country. In 2006 the government began to allow for direct selling, but it prohibited direct sellers from using multilevel compensation systems. Operating a multilevel compensation system can result in serious fines. Although in the United States multilevel marketing is completely acceptable, China views it as being too close to a pyramid scheme. Direct selling remains highly regulated, and teachers, doctors, and certain other professions are not allowed to engage in direct selling. To ensure that independent contractors are not gaining most of the sales through recruiting others, the Chinese government has mandated that the total commission of its independent contractors cannot exceed 30 percent of sales. Direct sellers must also have return-and-refund policies in place for independent contractors. Therefore, allegations that Nu Skin's Chinese independent contractors are engaging in a pyramid scheme represent a continuing challenge.

After the allegations were released, Nu Skin's stock price fell 38 percent within two days. China is an integral market for Nu Skin. It is estimated that consumers in China 65 years and older will increase by 66 million between 2015 and 2025, representing a lucrative market for Nu Skin's antiaging products. Findings of wrongdoing would significantly impact the company's growth within the country—and in turn its share price.

Nu Skin responded immediately and stated that it was launching its own internal review into the matter. CEO M. Truman Hunt denied that Nu Skin was operating a pyramid scheme. Nu Skin also criticized the findings of the reporters for *People's Daily*. The company claims that the reporters did not attempt to verify facts with the company and questions the accuracy and truthfulness of their claims.

However, just because Nu Skin denies being a pyramid scheme does not mean that a major violation or minor misconduct has not taken place. Nu Skin's initial review revealed some questionable practices among certain Chinese direct sellers that appeared to contradict the company's selling guidelines. Direct sellers are independent contractors and are not under direct control or supervision on a daily basis. There is no doubt that there will always be misrepresentation by independent contractors. This is why it is important that a strong code of ethics is enforced to minimize misconduct. M. Truman Hunt believes rapid expansion might have created a lapse in oversight, leading some employees in China to violate company guidelines. In a letter to customers, Nu Skin promised it would review employee selling practices and provide additional employee training to ensure that the sales force is thoroughly educated in appropriate selling practices. It also claimed it would cooperate fully with Chinese investigators. Despite these assurances, shareholders filed a class-action lawsuit against Nu Skin, maintaining that the company engaged in fraudulent sales practices that harmed investors. Share prices continued to fall, but have since rebounded.

Analysts at Deutsche Bank predicted that Nu Skin would probably only receive a small fine, which assured investors that the trouble would be short-term. CEO Hunt was also named in the investor lawsuit, which places him in a key role of defending his ethical leadership.

In March 2014 China fined Nu Skin $540,000. The fine was for selling products that were only approved to be sold in retail stores, as well as for not being able to back up certain product claims. Additionally, six salespersons in China were fined $241,000 for engaging in unauthorized promotions. The next month Nu Skin resumed its operations in China. It continued to face fluctuating share prices throughout the year.

CONCLUSION

Nu Skin's long-term success in China—traditionally a tough market for direct selling—remains to be determined. It is clear that even allegations of wrongdoing can significantly impact share prices and growth opportunities. In fact, the allegations of Nu Skin had an almost immediate impact on the stock of other foreign direct sellers operating in China. A day after the allegations, Herbalife shares had fallen 10 percent, while shares of USANA Health Sciences fell 12 percent. Nu Skin must ensure that Chinese employees are complying with its guidelines on direct selling. This requires a renewed emphasis on monitoring and training its Chinese independent contractors. Shortly after these allegations came to light, Nu Skin indefinitely suspended recruitment meetings in China and said they were modifying its training to better educate independent contractors in best practices.

On the other hand, supporters of Nu Skin believe that Nu Skin is being targeted because it is a foreign brand. The founder of Shanghai-based China Market Research Group has clearly stated that it is becoming more and more common for China to target foreign brands, and the climate is the worst he has seen in 15 years. This could lend weight to the allegation that the *People's Daily* unfairly targeted Nu Skin because it is a foreign brand. Because direct selling is still viewed as a questionable practice by many in China, the fact that Nu Skin is a direct selling firm may place it at an additional disadvantage.

Nu Skin has successfully faced down past challenges that threatened to damage the firm. In recent years the firm has become a major force in the global direct selling world with strong opportunities for growth. While this growth might be hindered by allegations such as these, successfully navigating through ethical issues will help Nu Skin get back on track. Much of its potential growth depends on how it will address future challenges.

QUESTIONS

1. How does a pyramid scheme differ from multilevel marketing?
2. Describe the accusations against Nu Skin in China and why they are so significant.
3. What should Nu Skin do to guard against questionable selling practices in the future?

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