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CLERK, U.S. DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

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17 and BRADLEY MacDONALD

18 UNITED STATES DISTRICT COURT
19 SOUTHERN DISTRICT OF CALIFORNIA

20 MEDIFAST, INC., a Delaware Corporation,
21 and BRADLEY MacDONALD, an individual,

CASE NO. **10 CV 0382** JLS WMc

22 Plaintiffs,

COMPLAINT FOR:

v.

- (1) DEFAMATION;
- (2) VIOLATIONS OF CALIFORNIA CORPORATIONS CODE SECTIONS 25400, et seq.;
- (3) UNFAIR BUSINESS PRACTICES (CAL. BUS & PROF. CODE SECTIONS 17200, et seq.)

23 BARRY MINKOW, an individual; FRAUD
24 DISCOVERY INSTITUTE, INC., a California
25 corporation; ROBERT L. FITZPATRICK, an
26 individual; TRACY COENEN, an individual;
27 SEQUENCE, INC., a Wisconsin service
28 corporation; WILLIAM LOBDELL, an
individual; iBUSINESS REPORTING, a
California business organization of unknown
form; and 'ZEEYOURSELF', an individual,

DEMAND FOR JURY TRIAL

Defendants.

INTRODUCTION

Plaintiffs, Medifast, Inc., and Bradley MacDonald (hereinafter "Plaintiffs"), for their
Complaint against Defendants Barry Minkow (hereinafter "Minkow"), Fraud Discovery Institute,
Inc. (hereinafter "FDI"), Robert L. FitzPatrick (hereinafter "FitzPatrick"), Tracy Coenen

CR

1 (hereinafter "Coenen"), Sequence, Inc. (hereinafter "Sequence"), William Lobdell (hereinafter
2 "Lobdell"), iBusiness Reporting (hereinafter "iBiz") and 'zeeyourself' (hereinafter "Zee")
3 (collectively "Defendants"), alleges as follows:

4 **NATURE OF THE ACTION**

5 1. This action arises out of the defamatory statements made, repeated and perpetuated
6 by Defendants through their respective websites and blog postings – frauddiscovery.net;
7 medifraud.net; sequence-inc.com/fraudfiles; ibizreporting.com; and the Yahoo! Finance message
8 board – that began on February 17, 2009, with the posting by Minkow and FDI of the false and
9 defamatory 'Expert Report on Take Shape for Life, a Division of Medifast, Inc.,' (hereinafter the
10 "Report" a copy of which is attached hereto as Exhibit 1, and incorporated by reference as if fully
11 set forth herein) drafted by FitzPatrick, at the direction of Minkow and FDI, as their retained
12 'expert.'

13 2. In his Report, which on information and belief was completed on September 15,
14 2008, but first published on February 17, 2009, on the FDI website, FitzPatrick falsely, and without
15 any basis in fact, accused Plaintiffs of running a Ponzi scheme, and a pyramid scheme; has likened
16 Plaintiffs to Bernie Madoff; and accused Plaintiffs of violating California Penal Code, Chapter 9, §
17 327, the "Endless Chain" statute.

18 3. Defendants, and each of them have perpetuated the false and defamatory statements
19 and opinions of FitzPatrick, and adopted them as their own, by republishing his alleged findings on
20 their own websites, and through their own postings containing similarly defamatory statements, on
21 various message boards within the internet community, in a scheme to drive down the stock price of
22 Medifast, in order that Defendants may make huge profits by short-selling Medifast stock in the
23 wake of their defamatory attacks on Plaintiffs' otherwise stellar reputations.

24 4. As a result of these baseless and defamatory attacks, which have continued to grow
25 over the past year, and continue relentlessly on a daily basis, Plaintiffs have suffered and will
26 continue to suffer damages to their professional and personal reputations.

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1 **THE PARTIES**

2 5. Plaintiff, Medifast, Inc. is a Delaware corporation with its principal place of business
3 at 11445 Cronhill Drive, Owings Mills, Maryland, 21117. Medifast stock trades on the New York
4 Stock Exchange ("NYSE") under the symbol "MED."

5 6. Plaintiff, Colonel Bradley T. MacDonald (Ret.) is an individual domiciled in the
6 state of Florida, and residing at 3800 N. Ocean Drive, #1250, Singer Island, Florida 33404.
7 MacDonald is the the Executive Chairman of the Board of Medifast, a Medifast shareholder, and
8 was the co-founder of Take Shape For Life, Inc. ("TSFL"), Medifast's direct sales division, and the
9 subject of the defamatory statements made by Defendants. His name and professional reputation
10 are intricately linked with Medifast and TSFL.

11 7. Defendant, Barry Minkow is an individual domiciled in the state of California, and
12 on information and belief, residing at 181 Calla Avenue, Imperial Beach, California, 91932.

13 8. Defendant, Fraud Discovery Institute, Inc. is a California corporation with its
14 principal place of business at 9747 Business Park Avenue, #218, San Diego, California, 92131.

15 9. Defendant, Robert L. FitzPatrick is an individual domiciled in the state of North
16 Carolina, and on information and belief, residing at 2808 Park Road, Charlotte, North Carolina,
17 28209. FitzPatrick was directly retained by Minkow and FDI to prepare the Report and was paid
18 for his services.

19 10. Defendant, Tracy Coenen is an individual domiciled in the state of Wisconsin, and
20 on information and belief, residing at 316 Milwaukee Street, # 416, Milwaukee, Wisconsin, 53202.

21 11. Defendant, Sequence, Inc. is a Wisconsin service corporation with its principal place
22 of business at 111 E. Wisconsin Avenue, #1230, Milwaukee, Wisconsin, 53202. On information
23 and belief, Coenen and her company, Sequence, Inc. have been retained by Minkow and FDI on
24 several occasions to aid in the targeted investigations of publicly-traded companies for alleged
25 fraud, thus directly targeting their services to a California domiciliary for their own profit.

26 12. Defendant, William Lobdell is an individual domiciled in the state of California, and
27 on information and belief, residing at 476 Broadway, Costa Mesa, California.

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1 13. Defendant, iBusiness Reporting is, on information and belief, a California business
2 organization of unknown form, with its principal place of business at 485 E. 17th Street, Suite 280,
3 Costa Mesa, California, 92627.

4 14. Defendant, 'zeeyourself' is, on information and belief, an individual domiciled in the
5 state of California, in Pasadena. Zee's current address is unknown to Plaintiffs at this time.

6 **JURISDICTION AND VENUE**

7 15. Jurisdiction is proper under 28 U.S.C. § 1332 because all parties are citizens of
8 different states, and the amount in controversy exceeds \$75,000, exclusive of interests and costs.

9 16. Venue is proper pursuant to 28 U.S.C. § 1391 because a substantial part of the events
10 or omissions giving rise to the claim have occurred or will occur in this judicial district.

11 **FACTUAL ALLEGATIONS**

12 **Medifast and Take Shape For Life:**

13 17. Since 1980, Medifast has been engaged in the production, distribution and sale of
14 weight management and health management consumable products marketed under brand names
15 including Medifast, Take Shape for Life, Hi-Energy Weight Control Centers, and Woman's
16 Wellbeing. Medifast's clinically proven approach to weight loss focuses on meal replacements
17 coordinated with medical practitioners and health advisors throughout the United States.

18 18. The Medifast program has been clinically tested and prescribed or recommended by
19 over 20,000 physicians nationwide.

20 19. Medifast sells its products through multiple business lines, including direct
21 purchasing through the Medifast website, in 'brick and mortar' weight loss centers, through a
22 network of approved physicians who prescribe or recommend Medifast to their patients, and
23 through direct sales by trained health coaches in the TSFL program. Medifast directly employs
24 approximately 369 people, currently.

25 20. TSFL is a wholly-owned subsidiary of Medifast. The TSFL program is a weight-
26 loss program designed by Dr. Wayne Andersen. It is an integrated support system that helps people
27 make the necessary changes in their lifestyles to create optimal health. By combining the Medifast
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1 product line with the support of health coaches and certified health advisors, TSFL is a simple,
2 convenient means for people to lose weight and maintain a healthy lifestyle.

3 21. TSFL works on a philosophy called the Trilogy of Optimal Health. As stated on the
4 TSFL website, Optimal Health can be broken down into three critical areas of life:

5 Healthy Body - physical health is the foundation of a happy and fulfilling life. Achieving a
6 healthy body requires two things: 1) reaching a healthy weight using Medifast Meals, and 2)
7 adopting the BeSlim philosophy which incorporates six core behaviors to help attain and
8 maintain Optimal Health.

9 Healthy Mind - how we feel about ourselves also affects long term Optimal Health. Through
10 personal development, learning ways to release stress, and creating time for ourselves, we
11 take control of our lives. That sense of freedom breeds happiness - another key to Optimal
12 Health.

13 Healthy Finances - debt causes stress - and stress can take a severe toll on both your
14 physical and mental health. By managing and eliminating debt, learning ways to budget, and
15 or seizing financial opportunities, you further yourself on the road to Optimal Health.

16 22. Anyone can purchase Medifast products without the use of a health coach, by going
17 to the Medifast website and placing an order.

18 23. If a Medifast customer is interested in obtaining the additional benefits of having a
19 personal health coach to provide counseling, mentoring and support, he/she can do so by contacting
20 a health coach through the Medifast website, at which point he/she will become a TSFL client, and
21 be entitled to all of the benefits of the program, inclusive of the same access to Medifast's products.

22 24. However, many TSFL clients began with the TSFL program upon the
23 recommendation of a friend or loved-one - someone who had tried TSFL and found success with
24 the program, and decided to help others obtain similar success by either becoming a health coach,
25 or by simply recommending the TSFL program.

26 25. As the Optimal Health philosophy indicates, beyond a weight-loss program, TSFL
27 also offers its clients an opportunity to increase their income if they choose to become a TSFL
28 health coach. A TSFL client can become a health coach by executing a Health Advisor Application
and Agreement, and by purchasing either the Application Pak or Career Builder Pak for a one-time
cost of \$199.

29 26. As stated in Medifast's Form 10-Qs filed with the Securities and Exchange
Commission ("SEC") and on the TSFL website, becoming a health coach is a business opportunity

1 that has a low cost of start-up and requires no holding of inventory, as all orders are shipped to the
2 end consumer directly from the company. No TSFL health coach is ever required to purchase
3 Medifast product up front with his or her own funds.

4 27. Health coaches receive training in how to counsel and support their clients, and must
5 pass a test in order to begin coaching clients. Training and support are continually available
6 throughout a health coach's career with TSFL.

7 28. Once certified, health coaches can sell Medifast products to others, and can also, if
8 they choose to, recruit other health coaches to join their team. Health coaches are not only sales
9 people, but provide all of their clients with personal counseling, mentoring and support as long as
10 they are on the Medifast program, a vital component of TSFL's success as a weight-loss program,
11 and what differentiates TSFL from other weight-loss programs.

12 29. The average 28-day supply of Medifast dietary supplements, sold in bundled paks,
13 currently retails for \$299.50. Each pak contains approximately 143 meals, for a total cost of \$2.09
14 per meal. At five meals a day on the Medifast system, that totals \$10.35 per day in cost to the
15 consumer. The counseling, mentoring and support of the TSFL health coach are included free.

16 30. A detailed description of the TSFL business model and explanation of the basis for
17 its continuing success is incorporated into Medifast's Form 10-Q reports filed with the SEC, and are
18 publicly available.

19 31. Health coaches receive commissions based upon the amount of Medifast food
20 products they sell to either non-health-coach clients, or to other health coaches. They do not
21 receive compensation as a result of their recruitment of other new health coaches. The only benefit
22 that health coaches receive from recruiting additional health coaches is a residual commission on
23 sales of Medifast products by the recruited health coaches.

24 32. In other words, all commissions earned are based on actual sales of actual Medifast
25 products to actual consumers.

26 33. Only approximately 1% of TSFL's total revenue is derived from sales of the health
27 coach application packages. The remainder is derived from product sales. In other words,
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1 Medifast's revenue as reported to the SEC reflects actual sales of actual products to actual
2 customers.

3 34. As reported in Medifast's 10-Qs to the SEC, at the end of the second quarter 2009,
4 there were approximately 4,650 active health coaches; by the end of the third quarter 2009, that
5 number had increased to approximately 5,800.

6 35. As the 10-Qs state, growth in TSFL revenues was driven by increased customer
7 product sales as a result of an increase in more experienced, active health coaches – bigger sales
8 force = higher sales.

9 36. According the the Center for Disease Control ("CDC"), over one-third of American
10 adults – more than 72 million people – are obese; sixteen percent of American children are obese.

11 37. According to the CDC, as of 2007 (the most recent year for which data is available),
12 23.6 million Americans suffer from diabetes; 1.6 million new cases of diabetes are diagnosed each
13 year; in 2007, 57 million Americans were considered to have "pre-diabetes."

14 38. Medifast and TSFL are specifically targeted to combat these negative trends in
15 American society and help America get healthy and stay healthy.

16 **Minkow's Get-Rich Scheme:**

17 39. Defendant, Barry Minkow is an ex-felon who was convicted on 57 counts of
18 securities fraud, and sentenced to 25 years in federal prison, of which he served seven. On
19 information and belief, Minkow is still paying off a restitutionary judgment of more than \$9 million
20 to the victims of his crimes.

21 40. Minkow founded FDI approximately five years ago. FDI purports to be a fraud
22 investigation company, but as the FDI website and Minkow's public statements make clear, the
23 prominent purpose of FDI is to make money by taking short positions in target companies' stocks.

24 41. FDI targets a publicly traded company and alleges to conduct a private investigation
25 of that company, seeking evidence of alleged fraud. While investigating, Minkow and his
26 associates take a short position in the target company's stock.

27 42. A short position is defined as when a person "borrows" stock from a third party, and
28 warrants to the stock lender that the loan will be covered at a later date. A person "borrows" stock

1 from a lender when the price is high, sells the "borrowed" stock high, and then gambles that the
2 price will drop before the loan is due, in order to re-purchase the "borrowed" shares at a lower
3 price, thus making a profit in the deal.

4 43. By taking a short position, and then releasing the negative results of his investigation
5 on the FDI website, posting video clips on YouTube, creating websites dedicated to bashing a target
6 company (such as www.medifraud.net), getting his associates such as Coenen and Lobdell (among
7 others) to repeat his false allegations of fraud on their websites, Minkow, FDI and their associates
8 are able to reap huge profits when the target company's stock plummets as a direct result of their
9 false and defamatory, and very public attacks.

10 **The First Attack:**

11 44. On February 17, 2009, Minkow, FDI and FitzPatrick first published FitzPatrick's
12 Report on the FDI website – www.frauddiscovery.net – and launched their new website –
13 www.medifraud.net (Exhibit 2 attached hereto and incorporated by reference as if fully set forth
14 herein). Posted on the medifraud website, were four other defamatory documents including a
15 memo entitled "Points of Similarity Between Madoff and Medifast" (Exhibit 3 attached hereto and
16 incorporated by reference as if fully set forth herein); an FDI Press Release (Exhibit 4 attached
17 hereto and incorporated by reference as if fully set forth herein); Lab reports from Bodycote Testing
18 Group, purporting to find lead in certain of Medifast's products and a letter from attorney
19 Christopher E. Grell regarding the alleged lead content (Exhibit 5 attached hereto and incorporated
20 by reference as if fully set forth herein).

21 45. Minkow also posted a video of himself on YouTube, making all of the same false
22 and defamatory statements that are asserted in the above-listed exhibits, and provided the link to the
23 video on the FDI and medifraud websites. That video is still available to viewers at
24 <http://www.youtube.com/watch?v=iGOpzCvUcxg>.

25 46. The Report purports to be the expert opinion of FitzPatrick, a self-claimed expert in
26 pyramid schemes, thus giving a false legitimacy to the blatantly false and defamatory allegations
27 contained therein.

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47. By way of example only, the Report falsely declares:
- A. that TSFL operates as an endless chain or pyramid scheme;
 - B. that TSFL's business model violates California Penal Code Chapter 9 § 327;
 - C. that like Bernie Madoff's Ponzi scheme, TSFL's unprecedented and inexplicable growth should be looked upon with suspicion;
 - D. that TSFL's growth is unsustainable and therefore Medifast's reporting to its shareholders is false and misleading;
 - E. that TSFL's income promise is based on success at endless chain recruiting, not retail selling;
 - F. that Medifast doesn't offer a viable income opportunity, but the illusion of one;
 - G. that it is the bogus income opportunity of Medifast, not its weight loss products, that account for its singular revenue growth and stock rise; and
 - H. TSFL's marketing lure is not legitimate.

48. By way of example only, the press release dated February 17, 2009, (Exhibit 3) falsely declares:
- A. that the income lure – that requires paying fees and buying TSFL products – is an endless chain scheme;
 - B. that Medifast is similar to Bernie Madoff's massive Ponzi scheme;
 - C. that Medifast utilizes a similar money transfer game as Madoff by delegating the recruitment aspect of the scheme to its "coaches" through the promise of outrageous returns;
 - D. that Madoff and Medifast both rely upon the transfer of money between investors within the scheme as opposed to money from retail sales generated outside the scheme;
 - E. that the lab reports and analysis by Christopher Grell (Exhibit 5) establish that the tested products were in clear violation of California's Proposition 65, without revealing that California's Proposition 65 does not apply to the

1 products tested; and without revealing that the levels of lead found in the
2 food are levels potentially harmful to a fetus *in utero*, not an adult; and that
3 there is already a warning on all Medifast products that pregnant women
4 should not use the products;

5 F. that Medifast's disclosures to new recruits and Wall Street are hopelessly
6 inadequate, implying that these alleged inadequacies are somehow in
7 violation of the law.

8 49. Following the first attack, Medifast issued a press release refuting all of Minkow,
9 FDI and FitzPatrick's false allegations. In response, FDI issued a second press release on February
10 18, 2009 (Exhibit 6 attached hereto and incorporated by reference as if fully set forth herein), in
11 which Minkow, FDI and FitzPatrick completely ignored the truth, and continued to perpetuate the
12 same lies and falsehoods regarding the TSFL business model in order to force the stock price to fall
13 further and allow them to reap higher profits in their short-selling scheme.

14 50. In that press release, Minkow, who admitted holding a short position in Medifast
15 stock, further makes false accusations regarding Medifast's choice of auditing firms, comparing this
16 choice to Madoff and his Ponzi scheme, without any basis in fact.

17 51. Following this first attack, Medifast's stock price fell almost thirty percent.

18 **The Second Attack:**

19 52. On May 21, 2009, Minkow and FDI launched a second attack on Plaintiffs by
20 posting on FDI's website and on the medifraud.net website, the following: a press release (Exhibit
21 7, attached hereto and incorporated by reference as if fully set forth herein); a letter to the Federal
22 Trade Commission Chairman and California Attorney General (Exhibit 8, hereto and incorporated
23 by reference as if fully set forth herein); a document entitled "Eleven Key Distinctions Between
24 Medifast and Avon" (Exhibit 9, hereto and incorporated by reference as if fully set forth herein); a
25 document entitled "5 Points of Similarity Between Medifast and YTB (YourTravelBiz.com)"
26 (Exhibit 10, hereto and incorporated by reference as if fully set forth herein); and a second Q-1'09
27 Updated "Expert Report" from FitzPatrick (Exhibit 11, hereto and incorporated by reference as if
28 fully set forth herein).

1 53. Again, these documents contain the same false and defamatory allegations, and
2 continue to perpetuate the already refuted falsity that Medifast is a Ponzi scheme and a pyramid
3 scheme and is in violation of the laws of California *and* New York, as well as Federal securities
4 laws.

5 54. The same day, Coenen posted the FDI press release (Exhibit 12, attached hereto and
6 incorporated by reference as if fully set forth herein) and the “5 Points of Similarity Between
7 Medifast and YTB” (Exhibit 13, attached hereto and incorporated by reference as if fully set forth
8 herein) on her website, Sequence Inc. Fraud Files, with her own by-line, thus adopting all of the
9 contents of those two statements as her own.

10 55. None of these statements were true when made, nor are they true now, and Minkow,
11 FDI, FitzPatrick and Coenen knew the statements were not true when they posted them. But
12 Medifast’s stock had bounced back following the release of its Q’1 2009 earnings and that result
13 was not profitable for Minkow and his associates. As such, it was necessary to ramp-up the attack.

14 56. The following day, on May 22, 2009, Minkow and FDI issued another press release,
15 (Exhibit 14, attached hereto and incorporated by reference as if fully set forth herein) which
16 perpetuated the same false and defamatory statements made previously, and asserted that FDI
17 would soon be rolling out YouTube videos of past Medifast “coaches” who enrolled in TSFL only
18 to conclude it was an endless chain, in order to “level the playing field for the potential Medifast
19 recruit.”

20 57. As of this filing, FDI has yet to post a single video of this kind.

21 **The Third Attack:**

22 58. When the second attack failed to have the same drastic effect on the price of
23 Medifast stock as the first, Minkow, FDI, FitzPatrick and Coenen tried again, beginning on June 9,
24 2009 with the posting of another press release from Minkow and FDI (Exhibit 15, attached hereto
25 and incorporated by reference as if fully set forth herein), along with a document entitled
26 “Summary Explanation of BJI Oddities” (Exhibit 16, attached hereto and incorporated by reference
27 as if fully set forth herein). This time, Minkow directly attacked the independence of Medifast’s
28 outside auditors, Bagell, Josephs, Levine & Company, LLC, falsely asserting that Minkow and FDI

1 had conducted an undercover investigation of the firm that revealed that Medifast's auditor was
2 "moonlighting as the company's stock promoter to investor clients."

3 59. No such conclusion could be reached, as the allegations are absolutely false.

4 60. On June 9, 2009, Medifast's stock price dropped over four and a half percent.

5 61. On June 24, 2009, Coenen posted an entry on her Sequence Inc. Fraud Files blog
6 entitled "Conflict of interest for Medifast auditors?" (Exhibit 17, attached hereto and incorporated
7 by reference as if fully set forth herein) once again falsely asserting that B JL Wealth Management,
8 an investment firm with the same address as the audit firm, recommended the purchase of Medifast
9 stock to an FDI operative, and further asserting that this would certainly be a conflict of interest for
10 Medifast and its auditor, Bagell, Josephs, Levine & Company.

11 62. Coenen and Sequence continued the attack on September 14, 2009, by posting an
12 entry on the Fraud Files blog entitled "Medifast and Take Shape For Life: Weight loss pyramid
13 scheme?" (Exhibit 18, attached hereto and incorporated by reference as if fully set forth herein).
14 Again, this entry makes false statements that health coaches are required to put up their own money;
15 that TSFL is a pyramid scheme; and Medifast is not complying with some unknown and
16 undisclosed legally mandated reporting requirements, among others.

17 **The Fourth Attack:**

18 63. On January 8, 2010, with Medifast stock prices at an all-time high over the past
19 several weeks, Minkow and FitzPatrick ramped up their attacks yet again. FitzPatrick released yet
20 another updated "expert report" this time falsely likening Medifast and TSFL to the housing bubble
21 and sub-prime mortgage crisis (Exhibit 19, attached hereto and incorporated by reference as if fully
22 set forth herein), along with another press release touting their investigation and false and
23 defamatory results (Exhibit 20, attached hereto and incorporated by reference as if fully set forth
24 herein).

25 64. This updated report contains even more false and defamatory statements, which
26 again, Defendants cloak in the alleged legitimacy of "expert opinion" in order to avoid culpability.

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1 65. By way of example only, this updated report falsely states:

- 2 A. that Medifast's true competitors are Amway and Pre-Paid Legal Services, among
3 other such pyramid schemes;
- 4 B. that the evolution of a Medifast consumer pyramid scheme on Main Street to an
5 inflated stock scheme on Wall Street has an obvious and unavoidable analogy –
6 the sub-prime mortgage crisis;
- 7 C. that getting a position on the TSFL pyramid pay plan requires a payment of
8 between \$100 and \$300 and each coach would also be required to purchase
9 inventory and marketing materials;
- 10 D. that Medifast is merely a pump-and-dump scheme, creating a deception on Wall
11 Street and misleading shareholders;
- 12 E. that more than \$6 million worth of shares were dumped by insiders in the two
13 months prior to the report – a statement that is directly contradicted by publicly
14 available SEC filings;
- 15 F. that the stock price is inflated out of all proportion to revenue because the future
16 expansion is presented as “unlimited”, just like the coaches’ mythical prospects
17 for earnings;
- 18 G. and again falsely comparing Medifast to Bernie Madoff.

19 66. Medifast immediately issued a press release refuting these false and defamatory
20 allegations, and informing the public that an independent investigation and review confirmed that
21 the TSFL model and Medifast's disclosures were in no way violative of any law.

22 67. Minkow immediately fired back the same day, with another defamatory press release
23 (Exhibit 21, attached hereto and incorporated by reference as if fully set forth herein), and on
24 January 12, 2010, with an “Open Letter” to MacDonald directly (Exhibit 22, attached hereto and
25 incorporated by reference as if fully set forth herein), ignoring the truth and once again attacking
26 Plaintiffs with false and defamatory allegations.

27 68. Once again, Coenen joined the attack with her postings on January 12, 2010 (Exhibit
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1 23, attached hereto and incorporated by reference as if fully set forth herein) and two postings on
2 January 13, 2010 (Exhibit 24 and 25 respectively, attached hereto and incorporated by reference as
3 if fully set forth herein), further adopting and disseminating the same false and defamatory
4 allegations that Medifast is misleading its shareholders, adding fuel to the fire and further driving
5 down the price of Medifast's stock.

6 69. By the close of the market on January 13, 2010, Medifast stock had dropped from
7 \$31.77 per share at the open on January 8, before this round of attacks, to \$27.00 per share.

8 70. On January 13, 2010, at 6:41 p.m., the plaintiff-side securities class action law firm
9 of Barrack Rodos & Bacine issued a press release further disseminating the false and defamatory
10 allegations of Defendants by announcing it was investigating Medifast for securities violations and
11 urging any potential plaintiffs to contact the firm immediately. The press release confirms that the
12 latest Minkow/FDI/FitzPatrick/Coenen attack successfully drove down Medifast's stock price by 14
13 percent (Exhibit 26, attached hereto and incorporated by reference as if fully set forth herein).

14 71. By the open of the market on January 14, 2010, Medifast stock had dropped to
15 \$24.86 per share.

16 72. On February 3, 2010, Minkow and FDI announced a new business venture and new
17 avenue for dissemination of their false and defamatory attacks on publicly-traded companies for the
18 sole purpose of make large profits by short-selling stock. Minkow and FDI joined forces with ex-
19 Los Angeles Times reporter, Lobdell and posted a new website – ibizreporting.com. It would be
20 the business of Lobdell and iBiz to further disseminate the false allegations of fraud in order to
21 make a profit in the stock market, as iBiz was admittedly funded directly by FDI's profits in short-
22 selling the stock of targeted companies. Their first attack was on Medifast (Exhibit 27, attached
23 hereto and incorporated by reference as if fully set forth herein).

24 73. Lobdell's "report" on Medifast includes the same false allegations against Medifast,
25 including the very specific and false statement that more than \$6 million worth of shares were
26 dumped by Medifast insiders in the two months prior to his report – a statement that is directly
27 contradicted by publicly available SEC filings, sources that should have been checked by an ex-
28 reporter such as Lobdell.

1 74. As a direct result of the Defendants' attacks on Medifast, anonymous posters on the
2 Yahoo! Finance message board devoted to Medifast have further perpetuated these attacks, and
3 have specifically targeted MacDonald personally. These attacks have become so far out of control,
4 that one anonymous poster, 'medisdead' has defamed MacDonald by referring to him as "Pimp-
5 Daddy Brad." Medisdead has shamefully attacked MacDonald's honorable military service to this
6 country and implied that MacDonald is a pedophile. (Examples of just some of these attacks on
7 MacDonald personally are attached hereto as Exhibit 28 and incorporated by reference as if fully set
8 forth herein).

9 75. Defendant, Zee is another one of these anonymous posters. Zee's postings contain
10 numerous false and defamatory statements, and perpetuate those contained in Minkow, FDI, and
11 Coenen's postings as well as those posted by medisdead. Some of Zee's defamatory statements
12 include:

- 13 A. Medifast is in violation of Federal Trade Commission regulations;
- 14 B. Medifast falsely advertises on its website;
- 15 C. Medifast executives are guilty of insider trading;
- 16 D. Medifast engages in deceptive sales and marketing practices;
- 17 E. Medifast management are hypocrites and unethical;

18 (Exhibit 29, attached hereto and incorporated by reference as if fully set forth herein). (Exhibits 1
19 through 29 will hereinafter be referred to as the "Defamatory Postings.")

20 76. Medifast stock closed the week of February 12, 2010 at a low of \$19.04 per share, a
21 drop of over 45 percent since its high of \$35.79 per share, prior to this latest round of attacks.

22 77. Central to FitzPatrick's 'expert opinion' is his false assertion that health coaches are
23 required to spend money out of their own pockets to purchase Medifast products, at retail prices,
24 and to re-sell those products to their clients, at retail prices; pay other illusory monthly fees to the
25 company; and incur the illusory cost and expense of marketing and selling the Medifast products.
26 This false assertion was adopted and repeated by Minkow, FDI, Coenen, Sequence, Inc., Lobdell
27 iBiz and Zee, and re-published by each of them in the Defamatory Postings.

28 78. Also central to this 'expert opinion' and to all of the assertions made by Defendants

1 in the Defamatory Postings is their collective false assertion that the only way health coaches make
2 money is by recruiting more health coaches, not by generating product sales.

3 79. This 'expert opinion' and all of the collective false assertions made by Defendants in
4 the Defamatory Postings rest on the false premise that TSFL does not sell a product, but sells a
5 business opportunity, an assertion that is directly contradicted by the TSFL website; Medifast's
6 website; and Medifast's SEC filings among other public sources.

7 80. This 'expert opinion' and all of the collective false assertions made by Defendants in
8 the Defamatory Postings rest on the false assertion that Medifast promises success to all of its
9 potential coaches and that Medifast promises a continuing and never-ending growth in profits to its
10 shareholders. But Medifast's SEC filings and the TSFL website clearly make no such assertions.

11 81. These are only an exemplary recitation of the false and defamatory statements
12 contained in the Defamatory Postings and the reasons for their falsity.

13 82. As of February 16, 2010, after the damage has been done, Minkow, FDI, Lobdell
14 and iBiz have taken down access to their Defamatory Postings and issued a statement indicating
15 that the investigation of Medifast has ended. The statement makes absolutely no mention of any
16 results, one way or the other. Coenen's postings on her Sequence, Inc. Fraud Files blog remain
17 available to readers. Thus, Defendants' allegations against Plaintiffs remain unretracted.

18 83. The use by Defendants of terms such as "Bernie Madoff" "Ponzi scheme" and
19 comparisons to the very recent sub-prime mortgage melt-down, the use of terms and concepts
20 bantered about in the media and used by politicians such as Main Street vs. Wall Street and "the
21 Great Recession" among others are very strategically chosen by Defendants and are specifically
22 intended to inflame the fears of investors and cause the depression of Medifast's stock.

23 84. These highly inflammatory, negatively-charged terms were carefully chosen by
24 Defendants to intentionally and maliciously defame Plaintiffs and to cause a panic among investors,
25 and did in fact have such an effect.

26 85. At all times, true and accurate information refuting Defendants' false assertions and
27 'expert opinions' was publicly available to them, but Defendants chose to ignore those sources and
28

1 instead intentionally mislead their audience by asserting that no such true and accurate information
2 existed, and to continue their attacks for their own pecuniary gain.

3 **FIRST CAUSE OF ACTION**

4 ***Libel Per Se***

4 **(Against all Defendants)**

5 86. Plaintiffs incorporate by reference each and every allegation set forth in paragraphs 1
6 through 85, above, as if fully set forth herein.

7 87. A cause of action for libel under California law accrued in California because
8 Defendants' libelous statements were published in California.

9 88. Plaintiffs have for many years enjoyed good reputations generally and in their
10 occupations and business. Plaintiffs have further enjoyed good relations with the public and
11 Medifast's shareholders to whom Defendants directed their false and defamatory statements.

12 89. By publishing the Defamatory Postings, Defendants intended to communicate to
13 others the false statements contained therein, which include but are not limited to those statements
14 outlined in the paragraphs above.

15 90. The statements in the Defamatory Postings are false because Plaintiffs did not
16 commit any of the acts alleged – Medifast is not a Ponzi or pyramid scheme; Medifast's products
17 are not unsafe for human consumption; and there is no conflict of interest between Medifast and its
18 auditor. Defendants knew or should have known that the statements were false when made, or did
19 not exercise reasonable care in verifying the truth or falsity of such statements before transmitting
20 and publishing these statements, or recklessly disregarded the truth or falsity of the statements.

21 91. By publishing the Defamatory Postings, Defendants intended to injure Medifast's
22 business reputation and to disparage its business. Defendants further intended to injure
23 MacDonald's personal and professional reputation.

24 92. The statements contained in the Defamatory Postings are libelous *per se* because: (1)
25 the statements are in printed form and are thus libel; (2) the statements ascribe characteristics that
26 have a tendency to injure and have in fact injured Plaintiffs in their business and occupation; and (3)
27 the statements claim Plaintiffs engaged in criminal conduct and other violations of law.

28

1 93. Plaintiffs have suffered damages proximately caused by Defendants' libelous action,
2 including but not limited to the loss of market capitalization of Medifast and the diminished value
3 to its common stock; loss in recruitment of new health coaches and correlating sales of Medifast
4 product and other growth opportunities and loss of potential revenue as a result of the defamatory
5 statements directly asserted against Medifast's products; as well as the incalculable damage to
6 MacDonald's reputation within his community as a result of Defendants' malicious attacks, in an
7 amount that is currently unknown, but in excess of \$270 million. By reason of Defendants' libel,
8 Plaintiffs are entitled to both general damages and all actual and compensatory damages proved at
9 the time of trial.

10 94. Defendants' actions in knowingly publishing the false statements were intentional
11 and done with express and implied malice on the part of Defendants. Defendants knew or should
12 have known that such statements were false when they published them. Nonetheless, Defendants
13 published such false statements recklessly and in conscious disregard of the truth. Further,
14 Defendants committed such acts maliciously, oppressively, and fraudulently, with ill will and an
15 evil intent to defame and injure Plaintiffs. Plaintiffs, therefore, seek an award of exemplary and
16 punitive damages in an amount to be proven at trial.

17 **SECOND CAUSE OF ACTION**
18 **(California Corporations Code §§ 25400 et seq.)**
19 **(Against all Defendants)**

20 95. Plaintiffs incorporate by reference each and every allegation set forth in paragraphs 1
21 through 94, above, as if fully set forth herein.

22 96. By virtue of the allegations set forth above, Defendants violated California
23 Corporations Code Sections 25400 et seq. Defendants violations were committed either directly or
24 indirectly within California.

25 97. Defendants knew that the statements they published to the trading public and to
26 Medifast shareholders were false and intended those false statements to influence the purchase and
27 sale of Medifast stock by Medifast shareholders, enabling Defendants to reap huge profits by short-
28 selling Medifast stock themselves.

1 98. Defendants' market manipulation was directly intended to depress the price of
2 Medifast stock.

3 99. As a proximate result of Defendants' acts and/or omissions occurring in California
4 with regard to Medifast, as alleged, Medifast's stock price was manipulated downward, and
5 Plaintiffs were injured by such downward manipulation.

6 100. Pursuant to the provisions of California Corporations Code Section 25500, Plaintiffs
7 are entitled to, and should be awarded, damages against Defendants for unlawful manipulation of
8 the price of Medifast stock.

9 **THIRD CAUSE OF ACTION**
10 **(California Business & Professions Code §§ 17200 *et seq.*)**
11 **(By Plaintiff, Medifast Only Against all Defendants)**

12 101. Plaintiffs incorporate by reference each and every allegation set forth in paragraphs 1
13 through 100, above, as if fully set forth herein.

14 102. Defendants' illegal stock market manipulation constituted unlawful, unfair, and/or
15 fraudulent business acts or practices by the Defendants, and each of them, all in violation of
16 California Business & Professions Code §§ 17200, *et seq.*

17 103. By publishing false and defamatory statements about Medifast and short-selling
18 Medifast's stock, Defendants engaged in fraudulent, wrongful and unlawful conduct, the purpose of
19 which was to unfairly damage Medifast's business for Defendants' economic benefit.

20 104. As a result of Defendants' unlawful scheme of attacking Medifast's reputation
21 through the publishing of libelous statements over the internet, thus scaring the investing public into
22 selling Medifast stock, and driving the stock price down in order that Defendants could reap huge
23 profits, Defendants have been unjustly enriched and Defendants should be required to disgorge all
24 profits made by way of their unfair business practices.

25 105. Defendants unfair business practices have caused substantial harm to Medifast,
26 through (but not limited to) decreased market capitalization and the diminished value to its common
27 shares; through loss in recruitment of new health coaches and correlating sales of Medifast product,
28 loss of other growth opportunities and loss of potential revenue as a result of the defamatory
statements directly asserted against Medifast's products; and the costs incurred in attempting to

1 deflect and overcome the damage inflicted by Defendants' Defamatory Postings, for which
2 Medifast is entitled to restitution in an amount to be proven at trial.

3 106. Medifast is further entitled to preliminary and permanent injunctive relief restraining
4 the Defendants, individually and collectively, each and all of them from committing further unfair
5 trade practices.

6 **PRAYER FOR RELIEF**

7 WHEREFORE, Plaintiffs hereby pray for judgment against Defendants in their favor on
8 each claim for relief set forth above and award them relief including, but not limited to:

- 9 1. For general damages in an amount according to proof at trial, but of approximately
10 \$270,000,000.00, well in excess of the jurisdictional minimum of this Court;
- 11 2. For special damages in an amount according to proof at trial, in an amount in excess
12 of the jurisdictional minimum of this Court;
- 13 3. For restitutionary damages according to proof at trial;
- 14 4. For disgorgement of Defendants' profits;
- 15 5. For punitive damages;
- 16 6. For prejudgment interest;
- 17 7. For costs;
- 18 8. For other applicable remedies as provided in the Civil Code, Corporations Code and
19 Business and Professions Code;
- 20 9. For injunctive relief; and
- 21 10. For such and further relief as the Court may deem appropriate.

22 Dated: February 16, 2010

LAZARE POTTER & GIACOVAS LLP

23
24 By: 

25 Robert A. Giacovas
Lainie E. Cohen
26 Attorneys for Plaintiffs
MEDIFAST, INC., and BRADLEY
27 MacDONALD

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JURY DEMAND

Pursuant to Federal Rule of Civil Procedure 38, Plaintiffs hereby request a trial by jury.

Dated: February 16, 2010

LAZARE POTTER & GIACOVAS LLP

By: 

Robert A. Giacovas
Lainie E. Cohen
Attorneys for Plaintiffs
MEDIFAST, INC., and BRADLEY
MacDONALD

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

Robert L. FitzPatrick

Submitted to: Fraud Discovery Institute

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

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Submitted: _____

Robert L. FitzPatrick
February 16, 2009

Update – February 16, 2009

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

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

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

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

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

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

Tipping Point into MLM

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

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

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

Reasonable Causes for Suspicion

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

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

² § 327. "Endless chain" schemes

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

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

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

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

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

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

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

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

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

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

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

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

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

Inexplicable Spikes

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

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

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

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

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

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

http://www.getyouhealth.com/BizDocs/bl_setting_your_business_in_motion_0806.pdf

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

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

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

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

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

Implausible Explanation

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

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

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

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

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

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

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

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

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

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

Conclusions

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

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

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

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

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

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

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

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

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

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

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

September, 15, 2008:

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

Overview and Opinion

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

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

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

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

⁹ § 327. "Endless chain" schemes

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

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

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

Despite strong anti-pyramid scheme statutes in some states such as California and Section 5 of FTC Act that treats pyramid schemes as *inherently* "unfair and deceptive trade practices," public understanding of the trickery and harm of endless chains, also called pyramid schemes or money transfers, has markedly *declined*. The internet is currently inundated with endless chain propositions, sometimes called matrix sales, investment clubs, "closed markets", gifting clubs, and a host of multi-level marketing schemes. They purport to sell various items from travel services to gold coins to fruit juice and diet pills. In virtually all cases, investments are garnered from the public with promises of rewards that are dependent upon a continuous recruitment of new investors, i.e., the endless chain. The inherent fraudulence of the endless chain marketing lure was succinctly and eloquently described by the U.S. Federal Trade Commission's (FTC) own expert on pyramid schemes Dr. Peter Vandernat in his May 2001 declaration, on the MLM scheme, SkyBiz.com.

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

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

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

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

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

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

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

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

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

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

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

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

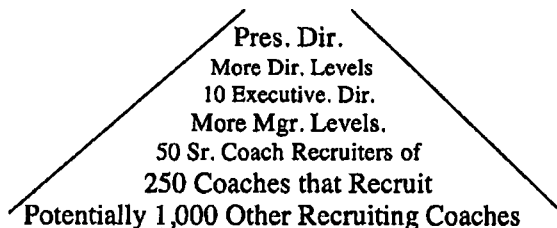
¹¹ <http://ag.ca.gov/newsalerts/release.php?id=1596>

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

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

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

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



When an individual coach enrolls five other participants with an aggregate purchase volume, the new coach moves to the level of “Senior Coach.” The TSFL pay plan then begins to offer escalating “bonuses.”

“Manager” level is gained when 2 Senior Coaches are enrolled below,

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

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

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

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

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

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

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

Medifast and the California "Endless Chain" Statute

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The California legislature replaced this "loophole" with the wording,

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

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

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

Earlier draft language of California's "endless chain statute

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

Current California Law

§ 327. "Endless chain" schemes

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

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

Final wording of California Penal Code 327 closed off loopholes for laundering money through product sales. It prevented the operation of endless chain schemes that claim to be "product-oriented" while gaining sales with promises of endless chain rewards to salespeople.

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

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

The final law has the definitive language:

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

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

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

Take Shape for Life's Pyramid-based Business Model

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

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

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

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

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

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

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

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

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

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

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

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

The Role of Take Shape for Life in Medifast

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

Medifast divides its business into four distribution channels:

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

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

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

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

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

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

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

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

Medifast management answered this question unequivocally.

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

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

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

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

The Limits of Unlimited

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

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

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

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

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

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

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

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

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

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

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

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

Medifast's Cover-up

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

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

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

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

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

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

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

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

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

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

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

Medifast's Pyramid Pay Plan

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Take Shape for Life's "Other" Product: An Income Opportunity

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

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

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

Contrast that with TSFL Website description:

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

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

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

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

Healthy Finances²⁶

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

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

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

http://www.getyouhealth.com/BizDocs/bl_setting_your_business_in_motion_0806.pdf

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

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

At the Bottom of the Pyramid: The Coach

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

Does it?

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

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

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

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

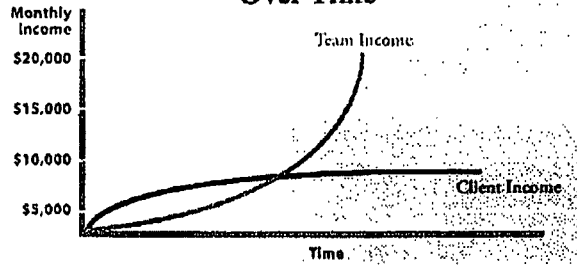
The calculations show that the highest possible number of coaches that could earn just \$500 a week is only 829 coaches out of 2,800. If just 829 earn \$500 a week, all 1,971 others would earn zero!²⁷ So, in reality, *far fewer* than 829 could *possibly* earn even a modest \$500 a week, *before all expenses.*

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

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

The *Take Shape for Life* website shows scenarios in which coaches earn \$8,000 and \$20,000 per month. The mean average income for coaches is actually \$143 a week with the great majority earning zero. A simple statistical analysis reveals that the maximum possible percentage of coaches that could earn \$8,000 (the lower figure) is 3% if they earned that amount; the other 97% would have to earn zero.

Team Income Will Exceed Client Income Over Time



Skills to Learn for Each Strategy

Client Focused
(\$100 - \$7,500 / month)

Client & Team Building Focused
(\$1,000 - \$25,000+ / month)*

Illustration of income averages is in the *Take Shape for Life* binder, Section on Business Motivation. ©2009 *Take Shape for Life*.
Reality Check: Mean average monthly income for a coach is \$640 with the great majority earning less. Making the midpoint in the illustrations above, \$3,900 for client focus and \$13,000 for team builder, the data shows that the maximum percentage that could earn these incomes is 1% and 3% respectively. If those percentages did earn the illustrated examples, all the other coaches would have to earn zero.

The Costs of Coaching

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

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

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

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

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

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

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

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

Coaching Business Realities

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

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

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

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

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

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

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

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

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

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

Summary Conclusions:

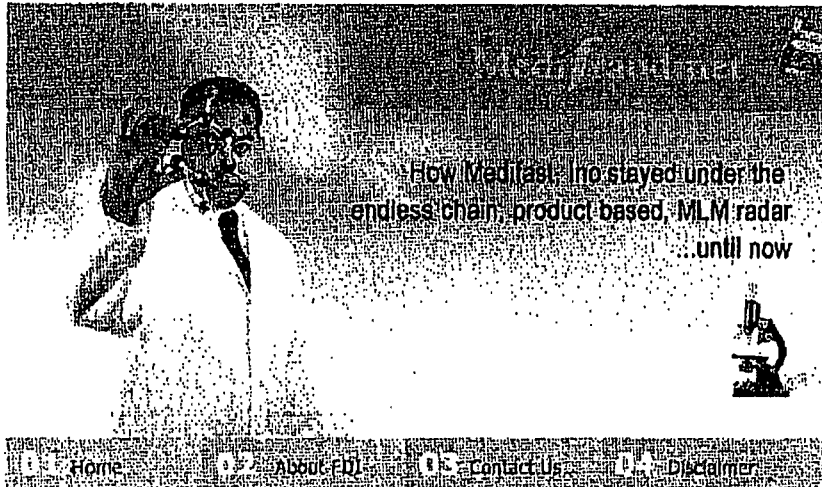
- *Take Shape for Life* has concealed an endless chain marketing scheme within its “coach” sales program. Among the means of concealment, it obscures the distinction between salespeople (coaches) and retail customers (clients) and presents a compensation plan that obscures the requirements for endless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

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

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

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





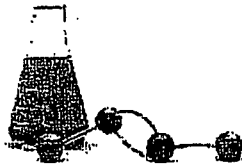
How Medifast, Inc. stayed under the endless chain-product based MLM radar... until now

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YouTube Video



[Click Here](#) to read the report just released to the Fraud Discovery Institute by expert Robert FitzPatrick of Pyramid Scheme Alert.

In the report, Mr. FitzPatrick shows how the *Take Shape For Life* division of Medifast is nothing more than a Endless Chain Pyramid Scheme.

Watch as Barry Minkow of the Fraud Discovery Institute compares the Endless Chain Pyramid Scheme business model of Medifast's *Take Shape For Life* division to the Ponzi Scheme perpetrated by Madoff. [Click Here](#) for the video

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Report details how Ponzi schemes and Endless Chain Pyramid Schemes are very much alike.

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For Immediate Release

Title: New FDI Report Reveals Madoff and Medifast Inc. (NYSE:MED) have too many points of similarity--launch www.medifraud.net website

Sub-title: Consumer group releases results of 6-month undercover investigation of Medifast, Inc (NYSE:MED) including lead testing, 29 page expert's report, product testing, YouTube video and Bernie Madoff comparison.

San Diego, CA Tuesday February 17th, 2009

The Fraud Discovery Institute, Inc launched www.medifraud.net, a web site containing the results of a 6 month investigation into Medifast, Inc (NYSE:MED), a New York Stock Exchange, publicly traded company.

The site contains a 29 page report by expert, Robert FitzPatrick that concludes: "Medifast, in fact, offers a misleadingly promoted income scheme that cannot possibly fulfill this promise. Medifast does not actually offer a viable income opportunity but the illusion of one, as portrayed in the endless chain mirage. The income lure - that requires paying fees and buying Take Shape for Life products - is an endless chain scheme. The vast majority of all consumers that Medifast enrolls in its "business opportunity" and who serve as the engines of its growth are doomed to fail."

The site also unveils critical points of similarity between the Bernie Madoff massive Ponzi scheme and the recruitment-based multi-level marketing compensation plan of Medifast, Inc. According to the recently released report, just as Bernie Madoff had no real trading profits to distribute to investors and instead relied upon monies paid to investors to come from new investors; in like manner Medifast utilizes the same money transfer game by delegating the recruitment aspect of the scheme to its "coaches" through the promise of outrageous returns (\$8,000 to \$20,000 per month) which is the bait to bring in new recruits whose efforts enrich the upline, not the new distributor/coach. "Both Madoff and Medifast are also closed systems," said Barry Minkow, Co-Founder of the Fraud Discovery Institute, Inc. "They both rely upon the transfer of money between investors within the scheme as opposed to money from retail sales generated outside the scheme."

The www.medifraud.net web site also contains lab reports from two FDA approved, independent labs that tested some of the popular Medifast, Inc. products and were then analyzed by lawyer and Dietary Supplement Safety Committee Co-Founder Christopher E Grell who summarizes that the tested products were in clear violation of California's Proposition 65 when he states that the: "Medifast Dutch Chocolate contains 1.48 mcg per serving is 296% or 2.96X's more than Prop 65 allows. The second test was 1.46 mcg per serving or 292% or 2.92X's greater."



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But perhaps the most surprising finding in this extensive, 6 month investigation was what was not found. According to Barry Minkow: "Medifast's disclosures to new recruits and Wall Street are hopelessly inadequate and worse than any other product-based MLM that we have ever encountered. They refuse to disclose failure and attrition rates which any potential party interested in the business opportunity ought to be aware of" said Mr. Minkow. "Moreover, while their disclosures about saturation, attrition and total number of coaches both active and inactive are not disclosed, their income opportunity figure of between 8 and 20 per month is not hard to find."



Points of Similarity Between Madoff and Medifast

[Click here for excerpts of the letter sent to SEC and FTC
arguing Ponzi and Endless Chain Pyramid Schemes are very much alike](#)

Recruiting Fresh Money

In Madoff's Scheme: He was responsible for recruiting new people into the scheme, whose money was used to pay earlier investors.

In Medifast: The company pushes the responsibility of recruiting new people into the scheme on to their "coaches", with funds from later coaches paying returns to earlier ones.

Closed System

In Madoff's Scheme: There were insufficient trading profits coming into the company. So money was transferred from new financial investors to pay off older ones within a closed system.

In Medifast: There is insufficient retail sales coming into the company. Investments are gained from "coaches", who must then recruit other coaches into the closed system to recoup their investments.

Affinity

In Madoff's Scheme: Financial investors were led to think they were in private and exclusive system with a unique income opportunity that protected them from Recession. Many encouraged their own friends to also invest.

In Medifast: Consumer investors are led to believe they are in a Recession proof program, a unique income opportunity with "no cap." Many encourage their own friends to also invest.

Unheeded Complaints

In Madoff's Scheme: Complaints about Madoff went unheeded by authorities, despite whistleblowers and evidence of fraud. The scheme appeared viable, and claimed to be a legitimate investment company. Some earlier investors were highly compensated and the others were unaware they were being defrauded; the numbers of participants were growing. By design and operation, the scheme caused the majority to lose. Regulator inaction allowed losses to mount.

In Medifast and other MLMs: Complaints about the nature of the MLM industry's false income promises and endless chain scheme go unheeded despite whistle blower reports and evidence of fraud – the constant churning of new recruits and major loss rates among consumer investors. The schemes appear viable and claim to be legitimate direct selling companies. Some early promoters are highly compensated. The others who fail and quit are unaware they were defrauded. By design and operation the schemes cause as many as 99% of consumers to lose money and 60-80% to quit each year. Regulator inaction allows losses to mount.



Law Offices of Christopher E. Grell

Attorneys At Law specializing in ephedra litigation, asbestos, dietary supplements, and PPA
The Broadlake Plaza, 360 22nd Street, Suite 320, Oakland, California 94612
Telephone: 510-832-2880 Fax: 510-832-2888

February 16, 2009

Dear Mr. Minkow;

I reviewed your expert's report on Medifast, Inc (including the update), the lab reports from BodyCote and Analytical Labs (both FDA approved labs), the Medifast web site with special focus on suggested frequency of consumption for the products tested and your 'Madoff/Medifast' pyramid and Ponzi comparison. As the Co-Founder of the Dietary Supplement Safety Committee with expertise on Prop 65, I have come to the following conclusions relating to your test results of certain popular Medifast products:

1. Medifast French Vanilla: The first test showed .973 mcg of lead per single serving. This is 109% or 1.09X's more than the .50 mcg of lead per day allowed under Prop 65. If the Attorney General ever decided to apply Prop 65 to this product, a warning label would be required based on just this one serving. If the recommended servings of two or three times a day are included, the number obviously goes up to between 309% or 3.09X's to 584% or 5.84X's higher than what Prop 65 would allow.

The second test of the same French Vanilla type product showed 1.25 mcg per single serving. This is 205% greater or 2.05X's higher than the .50mcg per day set forth in Prop 65. Again, if you added the total servings per day, the exposure would be substantially higher.

2. Medifast Dutch Chocolate: The test showed 1.48 mcg per single serving. This is 296% or 2.96X's more than Prop 65 allows.

The second test showed 1.46 mcg per single serving which is 292% or 2.92X's greater than Prop 65 allows.

In addition to the number of servings per day, these products are typically used with many other products that a person is supposed to take under the Medifast weight management plan. If these products showed similar lead levels, the potential for serious injury increases significantly.

Indeed, in order to sell as much product as possible and because, based on your expert's report, Medifast relies upon a closed system whereby little actual retailing to those outside the scheme or who are not "coaches", the "consumer" aka the

"coaches" are compelled to consume even higher than normal amounts of the product leading to even greater risk.

In short, it would appear, based largely on the company's realization that the best way to move product, when traditional retailing is not an option, is to get the "coaches" to purchase and consume the product in predictable and profitable time tables, leading to excessive consumptions of lead as well as other heavy metals that were detected in the tests that were done, that Medifast is putting profits over safety.

I also have some preliminary concern about Medifast's claim that their products do not appear to be involved with the "peanut" recall. As you may know, Medifast's competitor, Slimfast, made recalls relating to their products that contain peanuts, even though no reports of adverse events were made. Medifast on the other hand, has made no recalls of their nutritional bar products even though Medifast knows that these products are "Manufactured in a facility that uses tree nuts, wheat and peanuts."

In my view, the better part of wisdom would dictate that the company reconsider this apathetic approach to a very serious issue especially when certain competitors have already taken steps to protect the public against possible salmonella poisoning from contaminated products that either contain peanuts or that are "manufactured in a facility" where peanuts are used.

Indeed, in light of the fact that a number of Medifast's clinical studies, which Medifast relies on to promote the safety and efficacy of their products, were "funded" by Medifast, in my opinion, the safety of Medifast's products should be viewed with considerable suspicion.

Respectfully,

Christopher E Grell, Esq.



TESTING GROUP
www.bodycote.com
www.bodycotetesting.com

September 15, 2008

Fraud Discovery Institute Inc
9770 Carroll Center Rd
Ste F
San Diego, CA 92126

Attn: Christopher Grell, Esq
Barry Minkow

Re: Bodycote Job Number 108621

Dear Christopher Grell Esq, Barry Minkow

Enclosed is the revised report for Bodycote job number 108621. Per your request, we have changed the ID's as follows:

Originally Reported As:
Medifast 70 French Vanilla Shake
FV-52210 48133

Medifast 710 Dutch Chocolate Shake
DC-70-52110 49805

Now Reported As:
Medifast 70 French Vanilla Shake
FV-52210 48133
29498B2EXP110709OUD
Medifast 710 Dutch Chocolate Shake
DC-70-52110 49805
29648V1EXP010710OUD

We apologize for any inconvenience this may have caused you.

Please return or destroy the original laboratory report previously sent to you.

Sincerely,

Bodycote Testing Group

Eric W. Lindsay
General Manager
EWL:lo

Bodycote Testing Group
9240 Santa Fe Springs Road • Santa Fe Springs • California • 90670 • USA • Tel: +1 (562) 948-2225 • Fax: +1 (562) 948-5850

September 15, 2008

Fraud Discovery Institute Inc
9770 Carroll Center Rd
Ste F
San Diego, CA 92126

Attn: Christopher Grell, Esq
Barry Minkow

Job No: 108621R1

LO

REVISED LABORATORY REPORT

Samples Received: Two (2) Samples
Date Received: 09/11/2008
Original Report Issued: 09/12/2008
Purchase Order No: CREDIT CARD

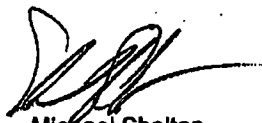
The samples were analyzed as follows:

Analysis

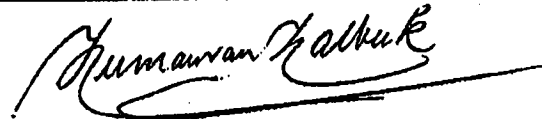
Page

Lead for CA Prop 65 by SOP 7130, Rev 5
Selected Metals by SOP 7040, Rev 9

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Michael Shelton
Senior Staff Chemist



Herman van Halbeek, Ph.D.
Senior Staff Chemist

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Lead for CA Prop 65 by SOP 7130, Rev 5
Quantitative Analysis Report
Isotope Dilution Inductively Coupled Plasma-Mass Spectrometry

<u>Sample ID</u>	<u>Lead(µg/g)</u>	<u>Serving Size (g)</u>	<u>Lead (µg/serving)</u>
Medifast 70 Dutch Chocolate Shake DC70-52110 49805 29648V1EXP010710OUD	0.0458	32.4	1.48
Medifast 70 French Vanilla Shake FV70-52210 46133 29498B2EXP110709OUD	0.0312	31.2	0.973
Detection Limit:	0.002		
Date Analyzed: 09-12-08			

Quality Control Summary

Sample: Medifast 70 French Vanilla Shake FV70-52210 46133, 29498B2EXP110709OUD

<u>Analyte</u>	<u>Sample Result</u>	<u>Duplicate Result</u>	<u>Average Result</u>	<u>Sample RPD</u>	<u>Spike Conc</u>	<u>Spike Result</u>	<u>Spike % Rec</u>
Lead	0.0312	0.0352	0.0332	12.0	0.995	0.968	94
Control Limits:				<25			80 - 120

Date Analyzed: 09-12-08

Selected Metals by SOP 7040, Rev 9
Quantitative Analysis Report
Inductively Coupled Plasma-Mass SpectrometryParts Per Million ($\mu\text{g/g}$)

<u>Sample ID</u>	<u>Parts Per Million</u> <u>($\mu\text{g/g}$)</u>	<u>Detection</u> <u>Limit ($\mu\text{g/g}$)</u>	<u>Serving</u> <u>Size (g)</u>	<u>Micrograms</u> <u>Per Serving</u>
Medifast 70 Dutch Chocolate Shake DC70-52110 49805, 29848V1EXP010710OUD				
Arsenic	0.035	0.003	32.4	1.1
Cadmium	0.035	0.003	32.4	1.1
Mercury	ND	0.003	32.4	ND (<0.1)
Detection Limit:	0.003	0.003	0.003	0.003

Date Analyzed: 09-12-08

Selected Metals by SOP 7040, Rev 9
Quantitative Analysis Report
Inductively Coupled Plasma-Mass Spectrometry

Sample ID	Parts Per Million ($\mu\text{g/g}$)	Detection Limit ($\mu\text{g/g}$)	Serving Size (g)	Micrograms Per Serving
Medifast 70 French Vanilla Shake FV70-52210 46133, 29498B2EXP110709OUD				
Arsenic	0.030	0.003	31.2	0.94
Cadmium	0.018	0.003	31.2	0.56
Mercury	ND	0.003	31.2	ND (<0.09)
Detection Limit:	0.003	0.003	0.003	

Date Analyzed: 09-12-08

Quality Control Summary

Sample: Medifast 70 French Vanilla Shake FV70-52210 46133, 29498B2EXP110709OUD

Analyte	Sample Result	Duplicate Result	Average Result	Sample RPD	Spike Conc	Spike Result	Spike % Rec
Arsenic	0.030	0.034	0.032	NA	2.5	2.88	114
Cadmium	0.018	0.018	0.018	NA	2.5	2.13	84
Mercury	ND	ND	ND	NA	0.25	0.210	84

Date Analyzed: 09-12-08

Sample: Laboratory Fortified Blank (LFB)

Analyte	Blank Result	Spike Conc	Spike Result	Spike % Rec
Arsenic	ND	2.5	2.14	86
Cadmium	ND	2.5	2.12	85
Mercury	ND	0.25	0.247	99

Date Analyzed: 09-12-08

September 16, 2008

Fraud Discovery Institute Inc
9770 Carroll Center Rd
Ste F
San Diego, CA 92126

Attn: Christopher Grell, Esq
Barry Minkow

Job No: 108690

JO

LABORATORY REPORT

Samples Received: Two (2) Samples
Date Received: 09/08/2008
Date Requested: 09/15/2008
Purchase Order No: NO CHARGE


The sample was analyzed as follows:

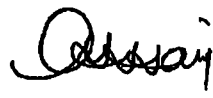
Analysis

Page

Lead for CA Prop 65 by SOP 7130, Rev 5

2


Michael Shelton
Senior Staff Chemist


Samina N. Hussain
Senior Chemist

Lead for CA Prop 65 by SOP 7130, Rev 5
Quantitative Analysis Report
Isotope Dilution Inductively Coupled Plasma-Mass Spectrometry

<u>Sample ID</u>	<u>Lead(µg/g)</u>	<u>Serving Size (g)</u>	<u>Lead (µg/serving)</u>
Medifast 70 French Vanilla Shake Lot 29651B3EXP123109OUD FV-52210 46133	0.040	31.2	1.25
Medifast 70 Dutch Chocolate Shake Lot 29649V1EXP010810OUD DC70-52110 49805	0.045	32.4	1.46

Detection Limit: 0.02

Date Analyzed: 09-16-08

Quality Control Summary

Sample: Medifast 70 Dutch Chocolate Shake DC70-52110 49805 Lot 29649V1EXP010810OUD

<u>Analyte</u>	<u>Sample Result</u>	<u>Duplicate Result</u>	<u>Average Result</u>	<u>Sample RPD</u>	<u>Spike Conc</u>	<u>Spike Result</u>	<u>Spike % Rec</u>
Lead	0.0449	0.0499	0.0474	NA	1.00	0.981	93

Control Limits: <25 80 - 120

Date Analyzed: 09-16-08



ANALYTICAL LABORATORIES IN ANAHEIM, INC.
2951 Saturn Street Unit C, Brea, CA 92821 Phone: (714) 524-9988 Fax: (714) 524-9926
Website: <http://www.analytical-lab.com>

Fraud Discovery Institute, Inc.
9770 Carroll Center Rd.
San Diego, CA 92126
Tel: (858) 549-7729 Fax: (858) 547-6359
Job #: 27031 Sample: Medifast Dutch Chocolate Shake
Lot #:

Attn: Barry Minkow
Receive Date: 09/15/2008
Report Date: 09/19/2008

Analysis	Claim	Result
Per Serving		
Arsenic		0.914 mcg/32.4g
Lead		0.914 mcg/32.4g
Cadmium		1.04 mcg/32.4g
Mercury		< 0.0324 mcg/32.4g

Method: ICP/MS for Mercury, Cadmium, Lead, Arsenic

Chemist: *[Signature]* 09/19/2008 Director, David Ji: *[Signature]* 09/22/2008



ANALYTICAL LABORATORIES IN ANAHEIM, INC.
2851 Saturn Street Unit C, Brea, CA 92821 Phone: (714)524-9988 Fax: (714)524-9926
Website: <http://www.analytical-lab.com>

Fraud Discovery Institute, Inc.
9770 Carroll Center Rd.
San Diego, CA 92126
Tel: (858) 549-7729 Fax: (858) 547-6359
Job #: 27030. Sample: Medifast French Vanilla Shake
Lot #:

Attn: Barry Minkow
Receive Date: 09/15/2008
Report Date: 09/19/2008

Analysis	Claim	Result
Per Serving		
Arsenic		1.11 mcg/31.2g
Lead		0.521 mcg/31.2g
Cadmium		0.618 mcg/31.2g
Mercury		0.0462 mcg/31.2g

Method: ICP/MS for Mercury, Cadmium, Lead, Arsenic

Chemist: *[Signature]* 09/19/08 Director, David Ji: *[Signature]* 09/19/2008



ANALYTICAL LABORATORIES IN ANAHEIM, INC.
2951 Saturn Street Unit C, Brea, CA 92821 Phone: (714) 524-9988 Fax: (714) 524-9926
Website: <http://www.analytical-lab.com>

Fraud Discovery Institute, Inc.
9770 Carroll Center Rd.
San Diego, CA 92126
Tel: (858) 549-7729 Fax: (858) 547-6359
Job #: 27030 Sample: Medifast French Vanilla Shake
Lot #:

Attn: Barry Minkow
Receive Date: 09/15/2008
Report Date: 09/19/2008

Analysis	Claim	Result
Arsenic		35.7 ppb
Lead		16.7 ppb
Cadmium		19.8 ppb
Mercury		1.48 ppb

Method: ICP/MS for Mercury, Cadmium, Lead, Arsenic

Chemist: *[Signature]*

09/19/2008

Director, David Ji: *[Signature]*

09/19/2008



ANALYTICAL LABORATORIES IN ANAHEIM, INC.
2951 Saturn Street Unit C, Brea, CA 92821 Phone: (714) 524-9988 Fax: (714) 524-9928
Website: <http://www.analytical-lab.com>

Fraud Discovery Institute, Inc.
9770 Carroll Center Rd.
San Diego, CA 92126
Tel: (858) 549-7729 Fax: (858) 547-6359
Job #: 27031 Sample: Medifast Dutch Chocolate Shake
Lot #:

Attn: Barry Minkow
Receive Date: 09/15/2008
Report Date: 09/19/2008

Analysis	Claim	Result
Arsenic		28.2 ppb
Lead		28.2 ppb
Cadmium		32.1 ppb
Mercury		< 1 ppb

Method: ICP/MS for Mercury, Cadmium, Lead, Arsenic

Chemist: *[Signature]* 09/19/2008 Director, David J. *[Signature]* 09/19/2008

For Immediate Release

Title: FDI debunks Medifast, Inc. (NYSE:MED) response to report

Sub-title: FDI raises new questions about Medifast, Inc's (NYSE:MED) use of a small, one office accounting firm to audit company books; calls it 'Madoff' like.

San Diego, CA Wednesday, February 18th, 2009

The Fraud Discovery Institute, Inc has just released a rebuttal to the Medifast, Inc (NYSE:MED) press release whereby the company claims that less than 1% of their commissions from 2008 is related to recruiting and none of that revenue is paid out to coaches as part of their compensation. But expert Robert FitzPatrick notes that: "This statement is yet another example of Medifast's policy of diversion and concealment concerning its endless chain pay scheme. It appears to refer only to fees for joining the scheme as a recruiter. These fees range from \$100 to \$300 per recruiter with the two fee options offering respectively higher levels of reward. **Medifast's endless chain money transfer is facilitated not in fees** – these are only the tickets of admission – but in product sales, which are gained by misleading income claims and promises, based on the endless chain pay scheme."

He continues: "By referencing only fees, Medifast omits from its denial that approximately 50% of Take Shape for Life's revenue from product purchases is transferred from recruits to Medifast's multi-level recruiters. The great majority of this sum is transferred to those in the upper levels of the recruitment pyramid. The endless chain lure and payment system used by Medifast is a deceptive marketing practice in which consumers are lured to pay fees and make product purchases as coaches and are offered rewards for recruiting other coaches in an endless chain. Income promises and claims are based on 'unlimited expansion' in a limited marketplace. The pay plan is a blue print for endless chain recruiting, offering far more rewards and incentives for recruiting than retailing. This recruitment-based pay plan is being hyped to new levels as a lucrative 'business opportunity' during a Recession."

Moreover, the company claims to be a member of the Direct Sellers Association, which is neither a government agency nor a consumer advocacy group and whose members have included such companies as 'Trek Alliance', which was prosecuted by the FTC for operating as a pyramid scheme and fined for making false income claims and 'Your Travel Biz', currently being sued by the Attorney General of California for violating Penal Code 327-the same claim made by FDI in their recent report about Medifast, Inc (NYSE:MED)

Barry Minkow, the Co-Founder of the Fraud Discovery Institute, Inc states that: "For Medifast Inc. to defend endless chain pyramid allegations by stating their proud affiliation with the Direct Sellers Association would be the moral equivalent of Bernie Madoff saying that he attended the Charles Ponzi School of Investment Advisors."



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Mr. Minkow also questions why a Maryland based, New York Stock Exchange Public company utilizes the services of a small, one location regional accounting firm (recently inspected by the PCAOB http://www.pcaobus.org/Inspections/Public_Reports/2008/Bagell_Josephs_Levine.pdf) with a total of six partners in the entire firm and who are located in Marlton, New Jersey to audit its books. "National accounting firms with experience in dealing with product based, multi-level marketing companies know from experience to insist on material disclosures in SEC filings of things like failure and attrition rates, saturation and other relevant data that any new 'coach' recruit would need to evaluate before taking the plunge into the Take Shape for Life business opportunity. The choice of this firm appears to strategically allow the company to get away with making fewer disclosures than any other public company in their industry." Mr. Minkow added "I believe that is yet another point of similarity with the Madoff enterprise."



For Immediate release

Title: Fraud Discovery Institute blasts Medifast, Inc (NYSE:MED) says record first quarter sales attributed to well-disguised and cleverly-concealed pyramid scheme

Sub Title: In new report, FDI compares points of similarity in Medifast, Inc. with two direct selling companies that share like compensation plans to establish incontrovertible evidence of material misrepresentation to recruits and to Wall Street investors

Thursday, May 21st, 2009

In a surprise move, the company known for its outspoken criticism of the direct selling industry, the Fraud Discovery Institute, Inc today released a report portraying direct seller Avon Corporation in a positive light (www.frauddiscovery.net).

To prove that Medifast, Inc (NYSE:MED) is a "scheme pyramid" business opportunity as evidenced by its record breaking first quarter earnings in the middle of a recession, the Fraud Discovery Institute, Inc enlisted the help of nationally recognized expert Robert Fitzpatrick, who issued an 11 point comparison between Medifast and Avon showing Medifast comes up short.

Some of the points that Mr. Fitzpatrick made included:

- Downlines are limited to 3 levels of recruiters at Avon. Medifast has 10 levels of downline recruiters. This is a huge distinction. It limits the potential for "kingpins" to develop that can control the business. It forces retail sales, since no one could make a lot of money merely on the personal purchases of a vast downline..
- The upline people receive a shrinking percentage of each sale as they rise in rank. At Medifast the upper levels get an increasingly larger piece of each sale. An upliner who is five levels away from the sale can receive more on the sale than the person who actually makes the sale. At Avon, you make more only if total sales volume grows.
- Avon does not link the value of its product to making money from selling it. Medifast claims that success in losing weight includes having financial security and then offers its own sales rep work as the way to achieve that security. At Medifast, endless chain recruiting becomes what you sell, the central focus.

"So the big question remains, how does Medifast hit record earnings?" asks Barry Minkow. "The key is all in what they do not say, like how many of their 'coaches' fail and quit within one year's time, or how much does the average 'coach' earn annually, or finally how much of these record sales come simply from the personal use of the coaches? These are all questions any reasonable person is entitled to ask before jumping into a business opportunity," said Barry Minkow.

And while Medifast falls far short of Avon, they do compare well with the recently prosecuted multi-level marketing company YTB Travel which, according to the California Attorney General,



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must, as of July 1, 2009, disclose to all prospects several things including the average income of potential business building recruits (including expenses against that income) and the amount of money earned by the average person who joins to build a business. To emphasize the seriousness of these material non disclosures, the Fraud Discovery Institute, Inc, created a website especially for Medifast (www.medifraud.net), where various documents are posted to corroborate these assertions.

"The real reason Medifast resists transparency in the area of disclosing attrition and collapse rates is the material adverse effect it would have on these 'blow out earnings' as no one would intentionally and knowingly sign up for a doomed by design, endless chain business opportunity," added Minkow.

**Jon Leibowitz,
Chairman, United States Federal Trade Commission**

**Jerry Brown
Attorney General, California**

Dear FTC Chairman Leibowitz and California Attorney General Brown:

Pyramid Scheme Alert and Fraud Discovery Institute join voices to formally ask that you initiate investigations of the sales company, Medifast Inc. (NYSE: MED), and in particular its multi-level marketing division, Take Shape for Life.

The recent prosecution and settlement of the California Dept. of Justice case against a similar company, Your Travel Biz.com (OBB: YTBLA.OB), establishes a standard for business practice and law enforcement that we ask you to apply also to this company.

The points of similarity between these two companies include:

1. Both identify themselves as "multi-level marketing" companies that offer all consumers an "income opportunity" based upon selling their product and recruiting other consumers into the business opportunity.
2. Both companies charge a fee of hundreds of dollars for the opportunity to earn income from reselling the income opportunity.
3. Both employ 10-levels of pyramid recruiters, which grants enormous financial leverage to the top recruiters while dooming the latest recruits to positions of loss unless they are able to build their own "downline" of new consumer/investors.
4. Both employ an "endless chain" incentive to consumers for investing in the business and purchasing the products. Regardless of market size and saturation in any given area both companies promote continuous and unlimited recruitment of more sales people.
5. Both utilize pay plans that drive endless chain recruiting activity over retail sales. The plans pay more to the recruiters than the retailers and apply payment formulas that transfer the greater share of total payments to the top levels of the pyramid.
6. Both companies showed remarkable growth in the midst of an economic downturn and within respective industries and product sectors that are contracting. Such dramatic upturns under these conditions are classic red flags.

A key reason for an investigation is the lack of transparency for consumers and shareholders who are solicited to invest in the Medifast "business opportunity" and securities. The same lack of transparency, which constitutes deception, was a cause for the 2007 FTC action against another multi-level marketing company, Burnlounge, Inc., which also charged consumers for the right to sell an endless chain income opportunity. In that case, the FTC alleged that Burnlounge "made deceptive earnings claims, and failed to disclose that most consumers don't receive substantial income, but lose money."

We, therefore, respectfully ask that requirements be applied to *Take Shape for Life* that were required in the settlement between the California Attorney General and Your Travel Biz.com and in the Burnlounge settlement with the FTC.

Take Shape for Life recruits consumers into its "business opportunity" without providing consumers with the basic information needed to do due diligence. Though the

company's viability depends on selling an income opportunity to consumers to become "coaches," neither consumers nor shareholders have information about the financial status of the coaches, their incomes, turnover rates, recruitment rates, profitability, costs, or odds for success. Among disclosures required in the YTB settlement, which are not provided to consumers or shareholders of Medifast, include:

- Median average income of sales representatives.
- Typical costs incurred
- Number of sales representatives who had quit the business
- Total number of sales representatives active and inactive.
- Percentage of sales representative who did not receive any compensation
- A statement that later recruits do not have the same chance for success that earlier ones do.

The settlement with Your Travel Biz.com also addressed a financial factor that is fundamental to legitimacy. This factor is how much of the company's total revenue is generated directly and ultimately from the sales representatives versus retail consumers.

We request that Medifast be required to disclose this basic and critical piece of information to both consumers and shareholders. In other words, while we applaud the effort of the California Attorney General and the renewed concern of the FTC to crack down on material non disclosures of certain income promises to potential recruits (as evidenced by the Proposed Business Opportunity Rule), we would simply request that a perception of detection and a perception of prosecution begin through the consistent application of what lead to the YTB action—specifically that the abovementioned disclosures be ordered by law enforcement to be made. In fact on page 16 of Medifast's Inc.'s most recent 10K, it states about the potential of these mandatory disclosures that: *"...should the governing body alter or enforce the law in an unanticipated way, there may be a negative result on the company's operations."*¹

In the financial markets, lack of regulatory oversight resulted in abuse and debased standards on Wall Street. The same consequences occur on Main Street as millions of consumers are solicited to invest in multi-level marketing "business opportunities." Oversight and regulation are more needed than ever during the current Recession. It is worth noting that both Your Travel Biz.com and Take Shape or Life have been promoted as safe havens in troubled economic times.

We respectfully request your immediate responses.

Sincerely,

Robert L. FitzPatrick
Pyramid Scheme Alert

Barry Minkow
Fraud Discovery Institute

¹ Please see http://www.sec.gov/Archives/edgar/data/910329/000114420409014237/v142765_10k.htm.



Eleven Key Distinctions Between Medifast and Avon

- 1. Avon has paid staff (district managers) that recruit the "Sales Leaders". This keeps the focus on sales and does not allow the channel to be nothing more than a self-generating recruitment machine. Avon invested in a professional sales management staff. Medifast, in typical MLM fashion, only has recruiters managing recruiters. The conflicts of interest are legion in that model. Everyone is living off everyone else. No one really represents the company or the customer.**
- 2. Avon extends credit to its sales reps. First orders are shipped and then billed. Future orders are fulfilled after earlier orders are paid off. This prevents forcing payments in advance, as Medifast and all other MLMs do.**
- 3. Only the "sales leaders," who are recruited by professional staff, can recruit. All other -- the great majority -- reps are not allowed to recruit unless they become "leaders". In Medifast, every "coach" is automatically an authorized recruiter. So, in Avon, most salespeople are actually selling product. They can't recruit. To remain active, they only need to place an order of any size each month to stay active.**
- 4. It only costs \$10 to become an Avon rep. Medifast charges \$299 or \$99, with many rewards to buy in at the higher level.**
- 5. Downlines are limited to 3 levels of recruiters at Avon. Medifast has 10 levels of downline recruiters. This is a huge distinction. It limits the potential for "kingpins" to develop that can control the business. It forces retail sales, since no one could make a lot of money merely on the personal purchases of a vast downline.**
- 6. The upline people receive a shrinking percentage of each sale as they rise in rank. At Medifast the upper levels get an increasingly larger piece of each sale. An upliner who is five levels away from the sale can receive more on the sale than the person who actually makes the sale. At Avon, you make more only if total sales volume grows. This promotes growing the business, not just rising in rank. The people making the sales earn a lot more than those doing the recruiting. At Medifast, the recruits collectively, earn more than the seller.**
- 7. The bottom level rep at Avon can earn 40% by selling Avon products on a retail basis to end-user customers. At Medifast the bottom level coach earns 14.7% of the sale to a client. The only way to make money at Medifast is to recruit more coaches.**
- 8. There is an obvious distinction between a sales representative and a customer at Avon while at Medifast, coaches and customers are blended so that recruiting is treated as "sales." At Avon, sales reps buy at wholesale and sell at retail. At**

Medifast, everyone pays the same! This leads inevitably to converting customers to sales reps.

9. Avon does not link the value of its product to making money from selling it. Medifast claims that success in losing weight includes having financial security and then offers its own sales rep work as the way to achieve that security. At Medifast, endless chain recruiting becomes what you sell, the central focus.

10. Advertising and brand awareness: Avon invests heavily in advertising its brand in support of its sales reps. Take Shape for Life does no advertising. All marketing funds are used in paying recruiters -- 50% of all revenue. The recruit at the bottom confronts a market with little name recognition against large competitors. This leads to selling the "opportunity" (which needs no brand) over the meal replacement product (which needs marketing support, but has none.)

11. There is one more factor that is more circumstantial, but still relevant. As we have noted, Bernie Madoff's ultimate mistake was his success when markets were down. His consistent success became a signal of wrongdoing. Medifast's strange rise in sales during a Recession is also a red flag. All its competitors' (Nutrisystem and Weight Watchers, for example) sales are down. Why is Medifast shooting up?

Looking at North America for comparison (Medifast is primarily in North America), Avon's sales reflect the real market for cosmetics. It declined in Q-1'09 over same period in 08. So did Revlon and L'Oreal. In fact, Avon's sales in North America are less now than they were in 2004 by 13%. The total number of reps is way up, yet overall sales are down. So, we can see that Avon's sales reflect a real market for its products, not just the market for an "income opportunity."

Robert L. FitzPatrick, Pres.
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RFitzPatrick@PyramidSchemeAlert.org
<http://www.PyramidSchemeAlert.org/>



5 Points of Similarity Between Medifast and YTB (YourTravelBiz.com)

- 1. Both Medifast and YTB International have 10 levels of commission payouts.** That means on any given sale of actual products or services, the person selling it will receive a small commission, while 9 other levels will receive a total commission exceeding the seller's commission.
- 2. Medifast and YTB both have seemingly "low" startup costs, with fees of \$300 and \$400 respectively.** Yet this fee looks far more significant when compared to the minimal fee of \$10 charged by Avon to new business builders. In reality, charging each new recruit several hundreds of dollars to join can add millions to the company's bottom line each year.
- 3. Neither Medifast nor YTB have disclosed the average income for one of their coaches or business builders.** YTB will now start disclosing this in July 2009 pursuant to a settlement with the California Attorney General, but apparently believed in the past that potential recruits didn't need to know such things.
- 4. Medifast and YTB both do not disclose their "churn rates."** They purposely do not disclose the number of people recruited during the year or the number of people who quit the business during the year, effectively concealing the failure rates for recruits.
- 5. Neither Medifast nor YTB disclose the amount of revenue the company receives from actual retailing of products or services,** versus how much revenue is actually derived from recruits who are personally consuming the products or services. This is an important distinction because revealing such numbers would show a potential recruit the true market for sales to third-party, bona fide customers.



Q-1'09 Updated
Expert Report on
***Take Shape for Life*, a Division**
of Medifast, Inc. (NYSE: MED)

Robert L. FitzPatrick

Submitted to: Fraud Discovery Institute

Re: Analysis of Business Models and Practices of
Medifast and *Take Shape for Life*; Review and
Analysis of Q-1'09 Financial Disclosures;
Implications for Medifast Shareholders

Robert L. FitzPatrick
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Email: RFitzPatrick@FalseProfits.com

Submitted: _____
Robert L. FitzPatrick
May 10, 2009

The financial disclosures released by Medifast, Inc. on April 29, 2008 for the company's activities during the first quarter of 2009 further confirm the conclusions I presented in the earlier, comprehensive report on this company.¹

The company's performance and the fate of shareholders depend on the marketing of an "endless chain" income proposition to consumers. The growth of the "multi-level marketing" division, *Take Shape for Life*, continues to be the only factor for significant revenue growth for Medifast. This sector depends entirely upon geometric expansion of its "coaches," that is, consumers who are persuaded to invest in the implausible income proposition.

Core Business in Decline

Excluding revenue gained from the selling of its endless chain income scheme, Medifast revenue *declined* by \$.6 million or 4% comparing Q-1'08 results for the same period of '09. This is in keeping with the trend of the meal replacement industry. Medifast's decline occurred despite opening additional corporate clinics and the introduction of a franchise model.

2008

Medifast Total Revenue at End of Q-1'08:	\$25.2 million
<i>Take Shape for Life</i> Revenue at End of Q-1'08:	\$9.8 million
Company Revenue Excluding TSFL:	\$15.4 million
TSFL Revenue as % of Total Medifast Revenue:	39%

2009

Medifast Total Revenue at End of Q-1'09:	\$33.7 million
<i>Take Shape for Life</i> Revenue at End of Q-1'09:	\$18.9 million
Company Revenue Excluding TSFL:	\$14.9 million
TSFL Revenue as % of Total Medifast Revenue:	56%

Redefinition as Peddler of Income Opportunity

As explained in the earlier report, Medifast has *redefined* itself from a diet and nutrition company into merely another variation of a multi-level marketing company, a mini-Amway. Its main and its true product is the sale of an "income opportunity" not meal replacements. In the classic multi-level marketing model, consumers are induced to pay fees, buy products and purchase marketing materials in the expectation of earning profits. The profits are based not from personal retail sales but from the purchases and sales of a "downline" of other recruits. The payment plans claim each new recruit can gain income from an endless chain of others whom they recruit to also invest. This income scheme can be recognized as the classic "robbing Peter to pay Paul." The Medifast scheme utilizes diet products as the vehicle for disguising and facilitating the money transfer. Without the continuous infusion of new investment capital from more independent distributors (called coaches), the company would collapse.

Medifast now has more in common with any of the companies that sell an income scheme based on purchasing inventory ranging from soap to vitamins and then recruiting others to do the same, than it does with companies such as Weight Watchers and Nutrisystem that actually sell diet products to the public.

¹ <http://www.pyramidschemealert.org/PSAMain/resources/Expert%20Report.Medifast.pdf>

Regulatory and Legal Minefields

The shift from selling diet products to selling an income proposition to consumers that is based on *continuous expansion* of coaches in a *contracting* marketplace has profound implications for Medifast shareholders. Extraordinary legal and regulatory issues arise from this transformation from a diet industry company to multi-level marketing, peddling an income promise.

A similar publicly traded company, *Your Travel Biz.com*, which charges consumers fees to become "travel agents" and then rewards them based on the recruitment of more "agents," has been sued by the California Attorney General as a "gigantic pyramid scheme."² Amway itself is the target of an enormous class action suit led by two of the country's premier class action law firms. The suit claims Amway is an endless chain scheme and that the vast majority of all new recruits, called "independent business owners", who are promised income based on recruiting other IBOs are "doomed by design" to lose money.³ Government regulators in England recently sought to close down Amway in that country "in the public interest" based on the revelations of false income claims and financial losses by tens of thousands of British consumers who had invested as Amway "independent business owners."⁴

The Federal Trade Commission had been notably lax in recent years under the Bush Administration in enforcing anti-fraud laws against pyramid selling schemes. However, this policy may be reversed in the coming years under the new Administration. The Direct Selling industry has focused nearly all its lobbying and political contributions on the minority party.

Limits on "Unlimited" Recruiting

Setting aside legal and regulatory issues, from a purely economic perspective the shift to multi-level marketing inextricably ties Medifast's continued growth to recruiting an ever-expanding base of "coaches." While a theoretical potential for market expansion of Medifast, based on gaining market share from competitors, might be viable, the continuous expansion of diet coaches is not.

In the April 29 press release, Medifast acknowledged that growth now depends on recruiting more coaches.

Growth in revenues for the segment was driven by increased customer product sales as a result of an increase in active health coaches. The number of active health coaches during the first quarter increased to approximately 4,000 compared with 2,200 during the period a year ago, an increase of 82% and up from 3,400 at the close of 2008.

The inherent restraints on Medifast's own growth are revealed by projecting the model forward just 10 years. To sustain the growth for 10 years, which the company has reported this past year, the number of coaches would expand from 4,000 to 1.6 million!

² <http://ag.ca.gov/newsalerts/release.php?id=1596>

³ Jeff Pokorny and Larry Blenn on behalf of themselves and those similarly situated, Plaintiffs, v. Quixtar, Inc., James Ron Puryear, Georgia Lee Puryear and World Wide Group, L.L.C.; Britt Worldwide L.L.C., American Multimedia Inc., Britt Management, Inc. Bill Britt and Peggy Britt, Defendants, Case No. C 07 0201, United State District Court, Northern District of California, Class Action.

⁴ <http://www.pyramidschemealert.org/PSAMain/news/AmwayCaseAppealed.html>

To put the limits on the model into a more realistic context, for *Take Shape for Life* to reach the size of its nearest and most similar competitor, Nutrisystem, it would need 160,000 "coaches." Whom would these coaches sell to or recruit? How many potential customers would be available for the coaches in a competitive marketplace? These types of simple projections reveal the trickery of selling "endless" chain income schemes and why they have become the targets of individual and class action lawsuits by "failed" consumers, why they were outlawed in China as frauds, and why the country of England sought to close down the veritable icon of this business model, the Amway Corporation, on the grounds of large-scale deception.

The coach recruitment business is a distinct activity that is essentially unrelated to the meal replacement industry. Its driving incentive is the sale of *income opportunity* for prospective coaches.

Industry trends show that the meal replacement market is contracting.⁵ However, as recent revelations of consumer and investor fraud have shown, the market for selling a bogus income proposition in the midst of the Recession is expanding.

Questions for the SEC

The sales of an endless chain income proposition has extraordinary implications for disclosure and transparency. With Medifast's fate now clearly dependent on the selling of this type of income proposition to consumers, shareholders and the SEC ought to know much more about the "coaches" whose fate and fortunes are the lynchpin of the company's future. On this subject, Medifast is *silent and secretive*.

For example,

- Medifast offers no information on its website or in SEC filings about the actual number of coaches recruited in any time frame or their dropout rates. It only offers a count of "active" coaches at the end of a quarter. Therefore, the churn rate, if there is one, is not disclosed.
- The actual number of retail customers per "coach" is also not disclosed.
- Similarly, the company does not disclose the percentages of incomes of coaches that are based on *personal* retail sales versus "bonuses and overrides."
- The average income of *all* coaches, active and inactive over and extended time, is not reported to shareholders or to prospective coaches.
- The percentage of annual revenue sourced directly from the coaches (their own fees and personal purchases) is not disclosed.
- Perhaps most important, regarding the coaches' profitability, the shareholders do not know how many coaches are in the various levels of the sales hierarchy and the proportions of commission payments made to each of the various levels of coaches. The *Take Shape for Life* pay plan allocates commissions to 10 levels of recruiters, who collectively gain more *per sale* than the person actually making a sale. If most of

⁵ Q-1'09 disclosures by diet industry giants Weight Watchers and Nutrisystem report year to year respective revenue declines of 11% and 25% and respective income drops of 18% and 37%. Medifast's anomalous rise in revenue, especially during a general economic decline, is a red flag of possible malfeasance.

the commissions are transferred to the few at the top, the thousands of newly recruited coaches are condemned to a futile struggle to get to the top, where only a few can ever be positioned.

Two Bucks a Day Peddled as "Unlimited Income"

From the current disclosure, Medifast revealed that it increased revenue in the *Take Shape for Life* segment by \$9.1 million between the end of Q-1'08 and the same period in '09. It also reported that the total of "active coaches" at the end of this time period increased by 1,800. This indicates that the total new revenue generated for each new coach is approximately \$5,000 (\$9.1 million ÷ 1,800). That total *revenue* figure per new coach reveals the absurdity of claims about "unlimited" *incomes* available to new coaches.

Medifast's website presents charts showing the potential for \$8,000 and \$20,000 *incomes per month*. Yet, with each new coach equating to just \$5,000 in new revenue, the *rewards* to those coaches must be minimal.⁶ 50% of all revenue is paid to the entire network of coaches in commissions but at least 70% of this commission is allocated to 10 levels of recruiters, not the salesperson at the bottom. So the actual *income* available to the newest coaches based on the new revenue gained is less than \$15 a week!

These per capita revenue and income figures presented in the Medifast press release – as small as they are and misleading in their incompleteness – are likely even more bogus. They are based only on the total *current* count of coaches at the end of the quarter, not the *cumulative* count of coaches that were churned through the company during the entire 12-month period. That truer number would reduce the per-coach revenue and income figures further.

Capital Investments Versus Retail Sales

Medifast does not reveal how much of the new revenue came directly out of the pockets of the new coaches, rather than from any retail sales they generated in the open market.

- Each new coach can pay as much as \$300 just to gain the right to get overrides from recruits.
- The *Take Shape for Life* meal replacement products cost about \$300 per month. Presumably most coaches are also buying the products for their own use and to give away as samples.
- Additionally, they must buy marketing materials from the company.

Fees, inventory purchases and marketing investments by the coaches themselves could, therefore, be a substantial portion of total *Take Shape for Life* revenue before any actual sales are ever made.

Questionable Legality

In the earlier report, I explained in detail why I thought *Take Shape for Life* was in jeopardy of violating California's law against endless chain schemes. That law is cited in

⁶ The earlier report presented a simple mathematical calculation that included the total number of coaches, and the total commissions paid (50% of TSFL revenue). It revealed that only a tiny percentage of coaches could possibly earn even a sustainable income equivalent to a minimum wage job.

the current class action suit against Amway, on which *Take Shape for Life* is modeled. It was also used as the basis for a recent FTC action against another multi-level marketing company, similar to *Take Shape for Life*, called BurnLounge. That company charged consumers fees to become "moguls" with the right to sell "downloaded music" through the company and then to receive rewards when they recruited other mogul/recruiters.⁷

The California law seeks to ban the use of the endless chain incentive for selling goods or for gaining financial investments.

Other states describe the endless chain incentive as a scheme in which the value of a product or the promised returns on investment depend on the "future action" (recruiting) of others. In those cases, the schemes are viewed as purveyors of unregistered "securities."

In my view, the *Take Shape for Life* income scheme potentially can be seen as a violation of such laws. The law in the state of New York is an example.

359-fff. Chain distributor schemes prohibited

1. It shall be illegal and prohibited for any person, partnership, corporation, trust or association, or any agent or employee thereof, to promote, offer or grant participation in a chain distributor scheme.

2. As used herein a "chain distributor scheme" is a sales device whereby a person, upon condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. A limitation as to the number of persons who may participate, or the presence of additional conditions affecting eligibility for such license or right to recruit or solicit or the receipt of profits therefrom, does not change the identity of the scheme as a chain distributor scheme. As used herein, "investment" means any acquisition, for a consideration other than personal services, of property, tangible or intangible, and includes without limitation, franchises, business opportunities and services, and any other means, medium, form or channel for the transferring of funds, whether or not related to the production or distribution of goods or services. It does not include sales demonstration equipment and materials furnished at cost for use in making sales and not for resale.

3. A chain distributor scheme shall constitute a security within the meaning of this article and shall be subject to all of the provisions of this article.

⁷ <http://www.ftc.gov/opa/2007/06/burnlounge.shtm>



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Fraud Discovery Institute blasts Medifast

Posted by [Tracy Coenen](#) on May 21, 2009 · [5 Comments](#)



In a surprise move, the company known for its outspoken criticism of the direct selling industry, the Fraud Discovery Institute, Inc today released a report portraying direct seller Avon Corporation in a positive light (www.frauddiscovery.net).

To prove that Medifast, Inc (NYSE:MED) is a “scheme pyramid” business opportunity as evidenced by its record breaking first quarter earnings in the middle of a recession, the Fraud Discovery Institute, Inc enlisted the help of nationally recognized expert Robert Fitzpatrick, who issued an 11 point comparison between Medifast and Avon showing Medifast comes up short. Some of the points that Mr. Fitzpatrick made included:

- Downlines are limited to 3 levels of recruiters at Avon. Medifast has 10 levels of downline recruiters. This is a huge distinction. It limits the potential for “kingpins” to develop that can control the business. It forces retail sales, since no one could make a lot of money merely on the personal purchases of a vast downline.
- The upline people receive a shrinking percentage of each sale as they rise in rank. At Medifast the upper levels get an increasingly larger piece of each sale. An upliner who is five levels away

Exhibit 12, pg. 01

from the sale can receive more on the sale than the person who actually makes the sale. At Avon, you make more only if total sales volume grows.

- Avon does not link the value of its product to making money from selling it. Medifast claims that success in losing weight includes having financial security and then offers its own sales rep work as the way to achieve that security. At Medifast, endless chain recruiting becomes what you sell, the central focus.

“So the big question remains, how does Medifast hit record earnings?” asks Barry Minkow. “The key is all in what they do not say, like how many of their ‘coaches’ fail and quit within one year’s time, or how much does the average ‘coach’ earn annually, or finally how much of these record sales come simply from the personal use of the coaches? These are all questions any reasonable person is entitled to ask before jumping into a business opportunity,” said Barry Minkow.

And while Medifast falls far short of Avon, they do compare well with the recently prosecuted multi-level marketing company YTB Travel which, according to the California Attorney General, must, as of July 1, 2009, disclose to all prospects several things including the average income of potential business building recruits (including expenses against that income) and the amount of money earned by the average person who joins to build a business. To emphasize the seriousness of these material non disclosures, the Fraud Discovery Institute, Inc, created a website especially for Medifast (www.medifraud.net), where various documents are posted to corroborate these assertions.

“The real reason Medifast resists transparency in the area of disclosing attrition and collapse rates is the material adverse effect it would have on these ‘blow out earnings’ as no one would intentionally and knowingly sign up for a doomed by design, endless chain business opportunity,” added Minkow.

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Exhibit 12, pg. 02

Comments

5 Responses to "Fraud Discovery Institute blasts Medifast"

1. *anonymous* says:
23 May 2009 at 5:40 am

It's amusing that the automated Medifast Spam Blog picked up your item.

2. *Emma* says:
19 June 2009 at 12:12 am

Is this about their Take Shape for Life program with the health coaches? That's not the only way Medifast sells their product. I sell Medifast as an affiliate (they're on Commission Junction) so I never even talk to anyone and don't have to recruit anyone and don't have to buy the product either. Maybe I'm losing money on recurring sales, but I just can't be bothered with the MLM model and whatever "training" program is involved and/or mandatory purchases.

I would think the failure rate of their coaches is probably similar to Weight Watchers, who also recruit from their successful dieters.

But at any rate, I would think their "record sales" is coming from all of their sales outlets — which includes just regular affiliates, their website and I think they are in some stores now too.

Trackbacks

1. *Fraud Discovery Institute blasts Medifast | Sequence Inc. Fraud ... - Medifast | Medifast Weight Loss | Medifast Diet Plans* says:
21 May 2009 at 8:14 pm

[...] post: [Fraud Discovery Institute blasts Medifast | Sequence Inc. Fraud ...](#) Tags: breaking-first, business-opportunity, enlisted-the-help, fraud, fraud-discovery, institute, [...]

2. *Medifast and Take Shape For Life: Weight loss pyramid scheme? | Sequence Inc. Fraud Files Blog* says:
23 September 2009 at 6:56 pm

[...] this year, Barry Minkow and Fraud Discovery Institute railed on Medifast, a company with a weight-loss plan being marketed with a multi-level marketing plan. The company [...]

3. *Medifast multi-level marketing scheme called into question by expert : Sequence Inc. Fraud Files Blog* says:
12 January 2010 at 1:58 pm

[...] report is an update to a mid-2009 report issued by FitzPatrick. The full text of the current report is found here. And here is my analysis of Medifast and Take [...]

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Tracy Coenen is a forensic accountant and fraud examiner in Chicago and Milwaukee who investigates white collar crimes, including cases of financial statement fraud, embezzlement, tax fraud, and insurance fraud. She is the author of Expert Fraud Investigation and Essentials of Corporate Fraud and more than 100 articles on fraud featured in industry publications.



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 - **JoeTaxpayer:** And it seems to me that people are so wanting to find a magic...
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5 Points of Similarity Between Medifast and YTB (YourTravelBiz.com)

Posted by [Tracy Coenen](#) on May 21, 2009 · [1 Comment](#)

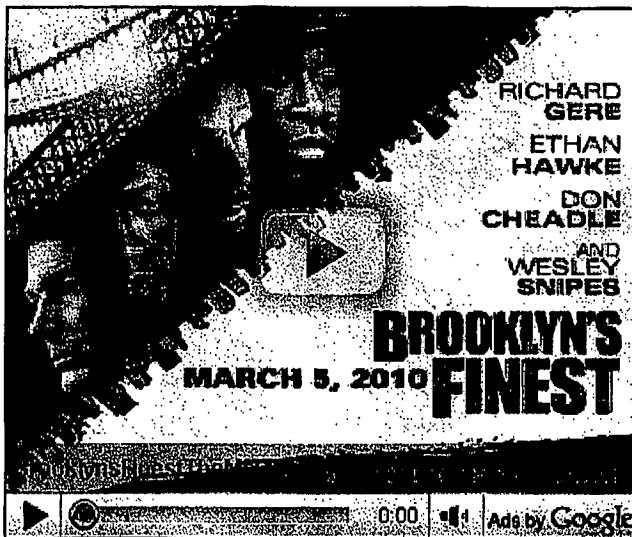
1. Both Medifast (NYSE:MED) and YTB International have 10 levels of commission payouts. That means on any given sale of actual products or services, the person selling it will receive a small commission, while 9 other levels will receive a total commission exceeding the seller's commission.
2. Medifast and YTB both have seemingly "low" startup costs, with fees of \$300 and \$400 respectively. Yet this fee looks far more significant when compared to the minimal fee of \$10 charged by Avon to new business builders. In reality, charging each new recruit several hundreds of dollars to join can add millions to the company's bottom line each year.
3. Neither Medifast nor YTB have disclosed the average income for one of their coaches or business builders. YTB will now start disclosing this in July 2009 pursuant to a settlement with the California Attorney General, but apparently believed in the past that potential recruits didn't need to know such things.
4. Medifast and YTB both do not disclose their "churn rates." They purposely do not disclose the number of people recruited during the year or the number of people who quit the business during the year, effectively concealing the failure rates for recruits.
5. Neither Medifast nor YTB disclose the amount of revenue the company receives from actual retailing of products or services, versus how much revenue is actually derived from recruits who are

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personally consuming the products or services. This is an important distinction because revealing such numbers would show a potential recruit the true market for sales to third party, bona fide customers.

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Comments

One Response to "5 Points of Similarity Between Medifast and YTB (YourTravelBiz.com)"

1. [Frank Thomas](#) says:
13 January 2010 at 12:13 pm

Kudos to Robert for his continued work.

Tracy, keep up the good work. Us oldtime consumer advocates (I am 73) get great real satisfaction knowing another generation will carry the torch

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Tracy Coenen is a forensic accountant and fraud examiner in Chicago and Milwaukee who investigates white collar crimes, including cases of financial statement fraud, embezzlement, tax fraud, and insurance fraud. She is the author of Expert Fraud Investigation and Essentials of Corporate Fraud and more than 100 articles on fraud featured in industry publications.



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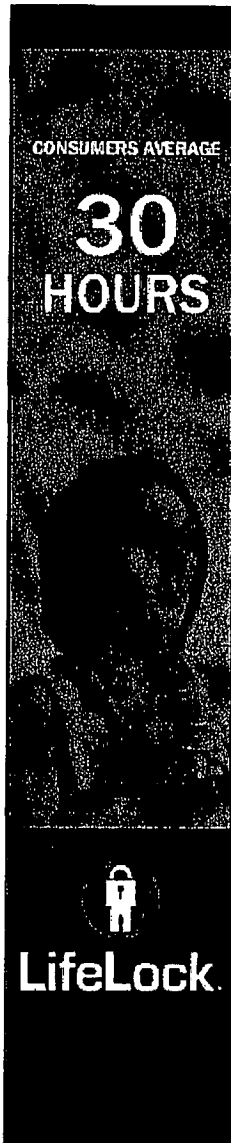
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For Immediate Release

Title: Non Profit Consumer Advocate Group teams up with FDI; files formal complaint against Medifast, Inc (NYSE:ME) with law enforcement

Sub title: FDI to roll out You Tube video interviews of past Medifast, Inc (NYSE:MED) "coaches" who enrolled in the business opportunity only to conclude it was an endless chain

Friday, May 22nd, 2009 San Diego, CA

Pyramid Scheme Alert Founder and nationally recognized expert Robert Fitzpatrick released a copy of a letter he authored that was sent to various law enforcement agencies yesterday that was also signed by Fraud Discovery Institute, Inc Co-Founder Barry Minkow (www.frauddiscovery.net). The letter essentially establishes irrefutable points of similarity between Medifast, Inc and YTB and essentially establishes that if applied consistency, the same result experienced in the YTB case would apply to Medifast, Inc (NYSE:MED).

The points of similarity between the 2008 prosecution of YTB and Medifast, Inc. and forwarded to law enforcement were first reported in a release by FDI earlier this week and include the following:

1. Both identify themselves as "multi-level marketing" companies that offer all consumers an "income opportunity" based upon selling their product and recruiting other consumers into the business opportunity.
2. Both companies charge a fee of hundreds of dollars for the opportunity to earn income from reselling the income opportunity.
3. Both employ 10-levels of pyramid recruiters, which grants enormous financial leverage to the top recruiters while dooming the latest recruits to positions of loss unless they are able to build their own "downline" of new consumer/investors.
4. Both employ an "endless chain" incentive to consumers for investing in the business and purchasing the products. Regardless of market size and saturation in any given area both companies promote continuous and unlimited recruitment of more sales people.
5. Both utilize pay plans that drive endless chain recruiting activity over retail sales. The plans pay more to the recruiters than the retailers and apply payment formulas that transfer the greater share of total payments to the top levels of the pyramid.
6. Both companies showed remarkable growth in the midst of an economic downturn and within respective industries and product sectors that are contracting. Such dramatic upturns under these conditions are classic red flags.



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The Fraud Discovery Institute, Inc also announced that they will begin profiling stories of past "coaches" of Medifast, Inc who attempted to succeed in the business opportunity but failed because of the endless chain, pyramid compensation plan that rewards recruitment over retailing. "Google is wonderful tool" said Barry Minkow, Co-Founder of the Fraud Discovery Institute, Inc. "When people who want to join Medifast, Inc first "Google" the company, YouTube will pop up and the potential recruit will be educated from those with first hand experience about how much money they did not make with a business opportunity that boasts of a potential "\$8,000 to \$20,000 per month in income."

By allowing past recruits to tell their story, FDI hopes to 'level the playing field' for the potential Medifast, Inc recruit.



For Immediate Release

Title: Former SEC Division of Enforcement lawyer sites potential independence and conflict of issues problems between Medifast (NYSE:MED) and their independent, outside auditors in four-page letter to Commission

Sub Title: Expert's letter sites possible stock-touting of Medifast (NYSE:MED) stock by company's single-officed, New Jersey based, outside auditors through their alleged independent investment entity. Expert also notes that PCAOB cited Medifast auditors for significant deficiencies in three of six audit engagements reviewed by them, or 50% of audits in their sample.

June 9th, 2009 San Diego, CA

Is the Medifast, Inc (NYSE:MED) independent auditor moonlighting as the company's stock promoter to investor clients? That appears to be the conclusion of a six-week investigation conducted by the Fraud Discovery Institute, Inc who today released several documents (www.frauddiscovery.net) including a letter from Michael Brown, who in addition to working in the SEC Enforcement Division served as the General Counsel for three nationwide securities broker-dealers which uniquely qualifies him to identify alleged impropriety and conflicts of interest issues.

According to the letter by securities expert Michael Brown and other evidence just released on a web site specifically dedicated to the Fraud Discovery Institute's almost year-long investigation of Medifast, Inc (www.medifraud.net), Medifast's outside accountants, Bagell, Josephs & Levine & Company, LLC, have over the past three years (http://bagelljosephs.com/abt_partners.html), also operated BJI Wealth Management, LLC (<http://bjlwealth.com/new/bjlwealth/gate.asp>) at the same address of the audit firm and have many of the same partners in both firms.

The investigation revealed that BJI Wealth Management, LLC recommended the purchase of Medifast stock to an operative of the Fraud Discovery Institute, Inc, which appears to cross the line of independence according to Mr. Brown, who asserts that *"if such conduct is indeed occurring, then it would appear that BJI's independence as MED's outside auditor has been compromised."*

Other evidence just released includes a recent and now resolved PCAOB (Public Company Accounting Oversight Board) letter of concern ([http://www.pcaobus.org/Inspections/Public Reports/2008/Bagell Josephs Levine.pdf](http://www.pcaobus.org/Inspections/Public%20Reports/2008/Bagell%20Josephs%20Levine.pdf)) and the various recent dismissals of Bagell Josephs Levine & Company, LLC by certain clients (please see http://www.google.com/search?sourceid=navclient&ie=UTF-8&rlz=1T4HPIC_enUS315US315&q=%2b%22bagell+josephs%22+%2bdismissed).



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The Fraud Discovery Institute, Inc has forwarded their findings to the newly appointed Director of the Division of Enforcement at the SEC, Mr. Robert Khuzami. According to Barry Minkow, Co Founder of the Fraud Discovery Institute, Inc "This is a disturbing finding and one that seems to pass the test of 'the appearance of impropriety'. In a post Enron/Sarbanes-Oxley environment, for an independent, outside auditor that is in this case the corroborator of Medifast's recent blow-out earnings-- which has subsequently induced massive public investment thus dramatically increasing Medifast's stock price-- to apparently have a stake in the game is troubling."

Summary Explanation of B JL Oddities

Bagell Josephs Levine & Company, LLC appears to operate solely from 406 Lippincott Drive, Suite J, in Marlton NJ 08053. The principal service of the firm is that of certified public accountants. The firm has registered with the Florida Department of Business and Professional Regulation (DBPR) under license number AD0019680 (expires 12/31/2009), however, no Florida address was found. The address shown in the DBPR database is the Marlton (NJ) address shown above. The partners and professionals of the firm include:

- Carl H. Bagell (Managing Partner)
- Neil Levine
- Marc G. Nochimson
- Glenn M. Josephs
- David Firestone
- Ciro Adams

Interestingly, although database information suggests that the firm is small in size, according to information in government databases, the firm sponsored one H1B visa application in 2007, and twelve H1B visa applications in 2008. No information was found which might explain the firm's need for such a large number of foreign workers. The Scientology Critical Information Directory lists the firm under the category of "Scientology-linked?" with the designation of "Yes".

Operating from the exact same address in Marlton (NJ) is the firm of B JL Wealth Management LLC. The principals of this latter firm ("Listed on the "Our Team" page of their website) include:

- Matthew Bagell
- Sam Brand
- Carl H. Bagell
- Charles Holmes

Based on information received, Carl H. Bagell utilizes the social security number 18X-XX-XXXX, and he was born in 08/1952. Matthew Bagell utilizes social security number 15X-XX-XXXX, and he was born in 10/1981. Because of the age difference between the parties, it is believed that the two individuals are father and son.

In a recent report issued by the Public Company Accounting Oversight Board (PCAOB), dated June 19, 2008, copy attached, after completing an inspection of the Bagell accounting firm, the Board identified "what it considered to be audit deficiencies". The report went on to state that, "The deficiencies identified in three of the audits reviewed included deficiencies of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential material to support its opinion on the issuer's financial statements."



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Conflict of interest for Medifast auditors?

Posted by [Tracy Coenen](#) on June 24, 2009 · [2 Comments](#)

Last week Barry Minkow and Fraud Discovery Institute released a report regarding the independence of the auditors of Medifast Inc. (NYSE:MED). The company is audited by Bagell, Josephs, Levine & Company. The audit partner happens to also be a part of BJL Wealth Management, an investment firm with the same address as the audit firm.

This becomes interesting when you consider that BJL Wealth Management recommended the purchase of Medifast stock to an operative of FDI. Is this a conflict of interest? It may be. Does the audit partner, in his role at the investment firm, make recommendations regarding Medifast stock? Does he have any financial interest in transactions involving Medifast stock? If the answer to either of these questions is yes, then the audit partner would have compromised his independence.

An auditor working in the capacity of an investment advisor does not automatically give rise to independence issues. In fact, over the last then years, the accounting powers that be were recommending that CPAs get involved in selling investments to generate additional revenue in their practices. However, when conducting an audit, the CPA has to draw a very clear line and not make recommendations regarding the buying or selling of securities of an audit client. The CPA also must not have any financial interest in the buying or selling of that stock. (i.e. He can't receive any income from the sale of securities of an audit client, even if it was someone else in the investment firm making the sale or recommendation.)

Another interesting factoid uncovered by FDI ... The PCAOB inspected six audits done by Bagell, Josephs, Levine, and found significant audit deficiencies in HALF of them. That's a pretty bad hit rate.

Exhibit 17, pg. 01

Interesting links:

FDI's website detailing its investigation of Medifast – <http://www.medifraud.net>
Sam Antar suggests Medifast should change auditors –
<http://whitecollarfraud.blogspot.com/2009/06/compelling-reasons-for-medifast-to.html>
Bagell, Josephs & Levine & Company – http://bagelljosephs.com/abt_partners.html
BJL Wealth Management – <http://bjlwealth.com/new/bjlwealth/gate.asp>

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Comments

2 Responses to "Conflict of interest for Medifast auditors?"

1. *Davis Freeberg* says:
[24 June 2009 at 11:47 am](#)

If this is true, it's a pretty big deal. How are public shareholders supposed to have confidence in the numbers when the auditors have a financial incentive to make sure that things appear rosy. Was this conflict at least disclosed in their 10-K filings or is this something that they've been trying to keep quiet?

2. *Medifast Blog* says:
[4 September 2009 at 8:59 pm](#)

if it is a solid investment, if the company in question was some other company other than medifast and BJI would make the same recommendation, then i dont see any conflict of interest. but if it was other way around, then there is something to think about

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Tracy Coenen is a forensic accountant and fraud examiner in Chicago and Milwaukee who investigates white collar crimes, including cases of financial statement fraud, embezzlement, tax fraud, and insurance fraud. She is the author of Expert Fraud Investigation and Essentials of Corporate Fraud and more than 100 articles on fraud featured in industry publications.



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