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**UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
WESTERN DIVISION**

THE HON. JUDGE GARY ALLEN FEESS, JUDGE PRESIDING

HERBALIFE INTERNATIONAL OF)
AMERICA, INC.,)
)
Plaintiff,)
)
vs.) NO. CV-07-2529-GAF
)
)
JULIA A. FORD, et al.,)
)
DEFENDANT)
_____)

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Los Angeles, California

Monday, June 1, 2009

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1 *Los Angeles, California, Monday, June 1, 2009*

2 *9:50 a.m.*

3 *-o0o-*

4 THE CLERK: Case number CV-07-2529-GAF, Herbalife
5 International of America, Inc., versus Ford, et al.

6 Counsel, please state your appearances, please.

7 MR. GATES: Good morning, Your Honor. Sean Gates
8 for Herbalife.

9 MR. JOLLY: Good morning, Your Honor.
10 Cameron Jolly for defendants and cross-complainants Fords.

11 MR. STEPHENS: Good morning, Your Honor.
12 John Stephens for the defendants and counterclaimants, the
13 Fords, the Roths, Dianna Thompson, and Jason Fisher.

14 MR. PATTERSON: Good morning, Your Honor.
15 Chuck Patterson for Herbalife.

16 THE COURT: All right. The matter is on today for
17 a hearing on multiple summary judgment motions. This is a
18 case where the defendants were Herbalife distributors who
19 left the company to join a competing organization, the
20 Melaleuca organization. Events surrounding their departures
21 have given rise to the claims and counterclaims that are now
22 before this Court.

23 Herbalife moves for summary judgment on the
24 defendants' counterclaims. Those counterclaims allege an
25 endless chain scheme, intentional interference with economic

1 advantage, unfair competition relating to prevention of
2 recruitment, and false advertisement relating essentially to
3 misrepresentation of retail sales.

4 The defendants move for summary judgment on their
5 counterclaims, and defendants also move for summary judgment
6 on the claims presented by Herbalife, which involve breach
7 of contract, violation of trade secrets, and unfair
8 competition, in sum and substance.

9 Let me address these motions this way and make a
10 few observations:

11 First of all, subject to the Court's ruling on the
12 endless chain scheme, and that's really what I want to hear
13 most about today because, in my view, in this case that's --
14 that is the elephant in the room, but put that aside for a
15 minute. If I didn't have that issue before me, I would
16 tentatively grant Herbalife's summary judgment motion
17 regarding the counterclaims.

18 As far as I can see from the review of this very
19 extensive record before me, looking at those facts which are
20 undisputed or without substantial controversy, I don't see
21 anything in the record that describes actionable conduct on
22 the part of Herbalife in response to defecting distributors'
23 efforts to compete.

24 So my tentative, again, subject to our discussion
25 on endless chain scheme, would be to grant that motion.

1 As to Herbalife's claim, to the extent that
2 Herbalife has any sort of claim left at this point where
3 they're seeking to enforce the noncompetition provision of
4 the contract, it's my conclusion that that provision is not
5 enforceable; and, hence, defendants' motion, to the extent
6 that that matter is still an issue, would be granted.

7 With respect to the nonsolicitation claim, my view
8 is that that issue is moot. I understand that there's some
9 concern that other distributors in the future might violate
10 that provision in one form or another having -- arising out
11 of context with these defendants but that does not change
12 the mootness analysis; so my view is that the motion should
13 be granted on mootness grounds with respect to that issue.
14 That is, the defendants' motion should be granted.

15 With respect to the contract and the related tort
16 and statutory claims based on misappropriation of trade
17 secrets, it's my view that those claims have been
18 established on the basis of the undisputed facts in the
19 record and that Herbalife's motion on that issue should be
20 granted. I do have some serious question as to what the
21 real damages are in this case and how Herbalife might go
22 about proving up such damages, but I think that that issue
23 has been established -- that those claims have been
24 established on the basis of this record.

25 But the big question and the one that eliminates

1 all of the other issues depending on how it's resolved is
2 whether or not Herbalife's business model is lawful under
3 the California endless chain legislation. People versus
4 Bestline and federal law as articulated in Koscot and
5 adopted in this Circuit in Omnitrition in a case that seems
6 to me to be completely indistinguishable from the present
7 lawsuit. The first prong under the Koscot test, I think, is
8 clearly established, but the second prong, which is whether
9 or not this is a company where the right to receive
10 compensation is in return for recruiting or for the sale of
11 product to ultimate users, that is the second element which
12 Koscot calls the *sini qua non* of a pyramid scheme or, I
13 guess, Omnitrition said that talking about Koscot.

14 I know that Herbalife has created the Ten Retail
15 Sales Rule and the 70 Percent Rule, but looking at the
16 record I have serious question as to whether or not those
17 are not exalting form over substance and aren't just there
18 for the purpose of creating the impression that the second
19 element of the Koscot test has been met.

20 As I look at the information that's been provided
21 to me, it appears to me that in the end what Herbalife is
22 interested in is generating sales to its downline
23 distribution chain. It doesn't keep any records of the
24 sales volume of product to people outside of its
25 distribution system and report on that. They do have this

1 process where they have their distributors provide them with
2 their ten sales data, and they provide periodic audits of
3 that, but in the end, looking at their annual report it's
4 plain that what is relevant to corporate success is simply
5 the moving of product out of Herbalife's warehouse into the
6 hands of its distributors. And at that point, their rewards
7 to their distributors are essentially based on volume of
8 their distributors, not necessarily retail sales.

9 So I have some question as to whether or not the
10 record establishes as a matter of law an endless chain or
11 whether or not on this record there are facts that should be
12 tried. If there are facts that should be tried, the
13 question is what would they be and how would we proceed in
14 terms of a trial with the presentation of issues to a jury
15 to answer if we were submitting a special verdict form to
16 the jury.

17 So that's where we stand, that's where I stand at
18 this point. Since I think the big question really focuses
19 on Herbalife's business model, I ought to hear from
20 Herbalife first and have them articulate for me why at the
21 very least this matter ought to go to trial on that
22 question.

23 MR. PATTERSON: Yes, Your Honor. Chuck Patterson
24 for Herbalife. May it please the Court.

25 THE COURT: Good morning.

1 MR. PATTERSON: The -- I was just commenting this
2 morning about what has always kind of puzzled me about the
3 Omnitrition opinion and that is there is a particular
4 paragraph in there -- let's see if I can find it -- well, I
5 can't find it right offhand, but the paragraph says if we
6 were to look only at distributors, Omnitrition is not an
7 endless chain scheme. That seems to be odd for several
8 reasons. It also seems to be -- simply because if you look
9 at Herbalife -- and this is in the record -- 75 percent of
10 the distributors in Herbalife are not supervisors or above.
11 They simply buy the product. They may buy it at a discount
12 and use it themselves. They may buy it for several other
13 purposes. They may make minor sales to friends, family.
14 They may make enough, as the record has shown, to make a few
15 car payments a month, to do something like that. Simply
16 they aren't engaged in whatever it is that Omnitrition felt
17 was the problem.

18 The second thing that I think that bothers me
19 about Omnitrition is the statement by the Court that
20 Omnitrition's Amway defense must fail at least on summary
21 judgment because the crucial evidence of the actual
22 effectiveness of its anti-pyramiding distribution rules is
23 missing.

24 THE COURT: The first point you were making I
25 recall, although not as clearly. The second point is very

1 much highlighted, I think, in the opinion, and the Court
2 focuses on that, and, understanding, I work for them. They
3 tell me what to do, and I have that case which is, I think,
4 controlling in this situation. And you may very well and
5 maybe others would find what the Court said to be odd, but
6 what it said is the law at this point in this Circuit; and
7 it seems to me not particularly helpful to Herbalife in this
8 case under these circumstances.

9 I do think that what they meant as to the first
10 point is: Look, we can't look at a piece of this
11 organization out of context. And the question is what is --
12 looking from top down, what is the objective of the
13 organization, and how does the organization achieve an
14 objective which is focused on retail sales.

15 I said if you look at that from Omnitrition's
16 standpoint, what Omnitrition wants to do, what Herbalife
17 wants to do here, which is to get its product into its
18 distribution line and at that point whether or not those
19 distributors sell to anybody else is of no significance to
20 them, really, in terms of corporate success. So I think
21 that's what they mean when they say that.

22 And am I not bound by that in making my
23 determination as to what to do in this case?

24 MR. PATTERSON: Well, I think, no. 1, I believe
25 that the decision is dicta. The real decision is were there

1 substantial factual questions that still had to be
2 determined that prevented summary judgment.

3 Secondly --

4 THE COURT: Yes, but that had to be because of the
5 application of a rule of law. I mean, we don't say that
6 reversals of grants of summary judgment hold only that
7 summary judgment was improper. I mean, it's because of the
8 articulation, some rule under the circumstances of the case,
9 right?

10 MR. PATTERSON: I understand that, Your Honor, and
11 I agree with that to a certain extent. However, the rule
12 articulated there, they say that they base on Koscot which
13 the second portion of Koscot says: "The right to receive,
14 in return for recruiting other participants into the
15 program, rewards which are unrelated to the sale of product
16 to ultimate users." There is no evidence in this case that
17 there is any kind of head-hunting fee, which is what Koscot
18 was looking for.

19 THE COURT: Well, but I don't know that it means
20 "head-hunting" fee. I mean, when I look at the compensation
21 scheme here, the compensation scheme is based upon sales
22 volume to contributors essentially; right?

23 MR. PATTERSON: Well, it is based on -- it is
24 based on sales volume, but it also requires that you make
25 retail sales.

1 Now, that is completely throughout every bit of
2 material that the company has.

3 THE COURT: But of no particular amount. I
4 mean -- there's no requirement, for example, that you have
5 to have 5 percent, 10 percent, 2 percent, any particular
6 number that would require that the retail sales be of that
7 level. I mean, it's just ten sales a month is the rule.

8 MR. PATTERSON: And you must sell 70 percent of
9 what you retain in any one month.

10 THE COURT: That can be to retail or downline.
11 You hold 30, sell 70 percent downline, you've met the
12 70 percent rule.

13 MR. PATTERSON: 75 percent of the downline,
14 Your Honor, by fact, Your Honor, are distributors who are
15 not involved in this same thing. They are end consumers,
16 they are discount customers. We have testimony in this case
17 from the defendants, at least one of them, Mr. Orr, that
18 50 percent of the people in his downline were discount
19 customers.

20 We have testimony from Mr. Graziani, who is a very
21 successful distributor, who says that 90 percent of the
22 people in his downline or the people who join Herbalife are
23 discount customers. They are not there for the purpose of
24 getting ahead in the business. They are either buying
25 product to make small sales and small money and be

1 successful in that way and not what we are talking about
2 here.

3 THE COURT: Are you saying that there's something
4 like -- those people at that level are kind of like Costco
5 members, that they get to be a distributor, and what they
6 get is they get the discount, and so they like the Herbalife
7 product and so this gives them an ability to buy the product
8 at a discount?

9 MR. PATTERSON: Yes, they do, Your Honor. They
10 get that ability to buy it at a 25 percent discount. They
11 can buy at retail if they want to. And as a matter of fact
12 in things like nutrition clubs which are a big thing at
13 Herbalife right now, they do buy at retail, and they buy at
14 retail in a club. And those have been found by the company
15 to be a very, very profitable piece of business. And the
16 company works very hard at this kind of thing -- Your Honor,
17 the company has been here for close to 30 years. It's been
18 overseen by the FTC, the SEC, the Attorney General of the
19 State of California, the Attorney Generals of all of the
20 other states in the United States and it has not yet, other
21 than in California in 1980 or '81, I believe it was, has it
22 been looked at as a pyramid scheme.

23 THE COURT: Does Herbalife have data where one
24 could look at their volume in a given year and say how
25 many -- what volume of its total sales are sales to sort of

1 bottom-level contributors who are simply members because
2 they like the product and they want to acquire it at a
3 discount?

4 MR. PATTERSON: We do, Your Honor.

5 THE COURT: Is it in the record?

6 MR. PATTERSON: It is in the record.

7 THE COURT: Tell me what I should look at.

8 MR. PATTERSON: And we would look for
9 Mr. Bruce Peters' declaration.

10 Is it in there?

11 Okay. We don't have it, but we have produced to
12 the other side those documents that show the difference
13 between forced and unforced volume, and unforced volume is
14 volume that is not used for the promotion of anyone to upper
15 levels. And that unforced volume as properly adjusted shows
16 somewhere around 60 percent of what is sold is sold at
17 retail. No other place it can go.

18 And, yes, we don't keep track of retail sales
19 because we don't require that people report retail prices to
20 us. We couldn't do it because we couldn't require that they
21 report prices to us because there's a concern about price
22 fixing if we know what prices they're being sold at, or
23 price maintenance.

24 There are other rules that are involved in this
25 and those are not just Ten Customer and 70 Percent and not

1 just the return of product, but also the fact that there is
2 what's called a "Matching Volume Rule."

3 In other words, in order to bring somebody up to a
4 supervisor level below you, you have to match the kind of
5 volume that they're making. You can't just do it for free
6 by using your own volume to pull them up.

7 And after they become supervisors, they can no
8 longer buy from you, they have to buy directly from
9 Herbalife. So you lose a lot of the advantages which happen
10 there, and it prevents people from making people as
11 supervisors, bringing them in for the purpose of trying to
12 get a bonus for doing this.

13 "Stacking volume" is another rule that is there
14 that says that you cannot -- in essence, it says: Don't go
15 purchase this stuff in somebody else's name just to increase
16 your own volume and therefore be able to get higher bonuses.
17 That's there. There's no doubt, and I don't think any
18 disagreement that Herbalife enforces its rules. It enforces
19 them vigorously.

20 There is discipline. It enforces them through
21 their computers, especially the stacking volume and matching
22 volume rules are enforced by computer.

23 There is enforcement of Ten Customer Rule as Your
24 Honor said. There is enforcement of the 70 Percent Rule
25 through audits that are performed by people who try to

1 qualify for President's Team. It's required at the time
2 someone leaves the company that they must show that they
3 have complied with the 70 Percent Rule.

4 And one thing that was pointed out by the
5 defendants, when you leave the company and you get a
6 buy-back, the people above you who earned anything on what
7 that volume was that you're having brought back have their
8 earnings taken away from them. A clear indicator that
9 you're not going to get these earnings if the company isn't
10 satisfied that there are retail sales out there. And that's
11 what the company works very hard and constantly to try to
12 do.

13 THE COURT: Do you -- you have indicated that
14 Herbalife has been in business for 30 years without being
15 found to be an endless chain.

16 Do you think that Omnitrition, if one follows the
17 Omnitrition rule, does it place Herbalife in a position
18 where Omnitrition itself, if literally applied in this case,
19 would result in a determination that Herbalife is an endless
20 chain?

21 MR. PATTERSON: No, I don't.

22 THE COURT: And how do you distinguish it, then,
23 from Herbalife?

24 MR. PATTERSON: Well, let's take several things.
25 Omnitrition says, first of all, that they're required

1 monthly statements of every month, required purchases of
2 product for every month. There is not in Herbalife. As a
3 matter of fact, you can become a supervisor without
4 purchasing any product from Herbalife if the people below
5 you are developing enough volume; that becomes a part of
6 your volume and that can count towards your supervisor
7 status and enable you to become a supervisor without ever
8 buying a single bit of product from the company or from
9 anyone else.

10 THE COURT: Anything else?

11 MR. PATTERSON: Well, there is, on top of that, I
12 think the difference between the way -- if we're adopting
13 and looking at Koscot and Amway, there is a difference of
14 the way that they look at what the effectiveness of the
15 rules are.

16 As I said, I cited that one section out of
17 Omnitrition about, you know, are they effective in
18 preventing. Amway held that the safeguards would ensure --
19 not that they would ensure retail sales, but held instead
20 that they were significant because they would encourage
21 retail sales. I don't think there's any way that anyone can
22 ensure retail sales, except to look at the evidence of how
23 many people do we have who came back to Herbalife with a
24 garage full of product and said, you know, "I've been duped
25 into this, and here's my product. I can't sell this

1 product. I'm not able to sell this product"? The evidence
2 is to the contrary. The evidence is considerably to the
3 contrary.

4 And there's not a single piece of evidence in this
5 case at any point in time with anyone who ended up with a
6 full garage full of product and was not able to retail it.
7 Every one of these defendants indicates it's the bread and
8 butter.

9 THE COURT: What was the term that you used when
10 you made reference to the bottom level so-called
11 distributors who essentially join to acquire product at a
12 discount? You used a term for -- you said 60 percent of the
13 sales were to those people, and that's -- used a term for
14 that.

15 MR. PATTERSON: Discount customers.

16 THE COURT: Just "discount customers"?

17 MR. PATTERSON: Yes.

18 THE COURT: And that evidence is part of
19 information from Mr. Peterson, which is not part of the
20 summary judgment record; is that correct?

21 MR. GATES: It is part of the record. Peterson is
22 not the 70 percent, 50 percent is.

23 MR. PATTERSON: The information is a part of the
24 record, yes.

25 THE COURT: Where is it?

1 MR. PATTERSON: It would be, I think, in
2 Mr. Gates' declaration.

3 THE COURT: All right. Just point it -- don't
4 have to read it. Just tell me where we need to look so when
5 we go back and write our order, we can make reference to it.

6 In the meantime if -- other than this issue, are
7 there any of the issues that I raised in the tentative that
8 you would like to discuss, other than the endless chain
9 issue?

10 MR. GATES: If I may, Your Honor?

11 THE COURT: Yes.

12 MR. GATES: I understand the endless chain issue,
13 the question would be if there is an issue of material fact
14 as to whether or not Herbalife is an endless chain, under
15 what claim do defendants have standing to challenge that
16 because if they don't have standing under 17200 and 17500,
17 which I understood you could indicate was your tentative,
18 they certainly don't have standing to enforce a criminal
19 statute.

20 THE COURT: So your position is if they don't have
21 standing to enforce the endless chain at all, then, all of
22 the other claims fail?

23 MR. GATES: That's correct, Your Honor.

24 THE COURT: All right. Is there anything else you
25 want to say about your claims?

1 Mr. Patterson.

2 MR. PATTERSON: I'm sorry, Your Honor.

3 Essentially the point I think we have is that
4 these numbers indicate and would indicate that retail sales
5 are being made. We know -- the company wouldn't be in
6 business this long. The vice of an endless chain scheme is
7 that it eventually fails, falls within itself; and after
8 30 years it has not fallen within itself.

9 THE COURT: I'm asking about the other claims,
10 though, now.

11 MR. PATTERSON: I'm sorry.

12 THE COURT: Any of your claims, not -- the
13 counterclaim, I understand the point is: Look, they just
14 don't have standing to enforce endless chain, and if they
15 don't have standing to do that, they can't bring anything
16 else. But there then are the affirmative claims of
17 Herbalife, some of which I've indicated I would summarily
18 adjudicate in favor of the defendants.

19 Do you wish to be heard on any of those?

20 MR. PATTERSON: I'm sorry. Mr. Gates was handling
21 our motion.

22 MR. GATES: In favor of defendants, Your Honor?

23 THE COURT: Yeah.

24 MR. GATES: The 17200 standing and 17500 standing?

25 THE COURT: No.

1 MR. GATES: I'm not sure which claims you are
2 referring to that's --

3 THE COURT: You have affirmative claims which I've
4 indicated what my ruling is on summary judgment with respect
5 to your affirmative claims, some that I would deny, some I
6 would grant in favor of the defense, and a couple I would
7 deny. I'm just asking if you want to be heard on it, now's
8 the time. If you don't, then, I'll hear from the defense.

9 MR. GATES: No, we'll submit on the papers,
10 Your Honor.

11 THE COURT: All right. Then, let's hear from the
12 defense.

13 And, I guess, counsel, we ought to start with the
14 endless chain question because I do have -- I did not see in
15 the record, and I'm going to have to go back and look at the
16 record, as indicated by counsel, that essentially there's a
17 60 percent of the volume is retail sales to discount -- this
18 bottom level of distributors who are essentially discount
19 buyers. And if you want to address that, what's your
20 position as what the record is with respect to that, and how
21 I should construe it?

22 MR. STEPHENS: Well, two points, Your Honor. One
23 is that I don't believe it is in the record, and I certainly
24 have not seen that in the record, and I don't really see how
25 it could be in the record because, as Herbalife has

1 indicated, it does keep track of retail sales and, in fact,
2 does not keep track of the sales made by its distributors.

3 Now, the distributors includes supervisors and up
4 and also which get -- they get a 50 percent discount. And
5 the distributors on the entry level who have to sign a
6 distributorship agreement with Herbalife, including all the
7 covenants and restraints and so forth, and they get a
8 25 percent discount. Those -- I'll call them
9 distributors -- they've been called by Mr. Patterson
10 "discount buyers." They may buy from supervisors,
11 therefore, based on the statement by Herbalife that it does
12 not keep track of retail sales, I don't see how that
13 statistic can be in the record. And believe me if it was in
14 the record, I mean we would have addressed it.

15 In response to our Omnitrition portion of the
16 complaint -- sorry, of the motion, you essentially have the
17 declaration of Ms. Jenny Heinrich, and she does not deal
18 with this issue of 60 percent. And I just do not think it's
19 there.

20 I do agree with Your Honor on Omnitrition, and I
21 had the exact same reaction as Your Honor did, in that if
22 Herbalife does not keep track of its retail sales -- and
23 critical evidence, according to Omnitrition, is whether or
24 not the policies, the Ten Customer Rule and to a certain
25 extent the 70 Percent Rule, effectively encourage retail

1 sales, how could we ever have a trial where Herbalife can
2 prove that those rules effectively encourage retail sales?

3 Also, in our motion, we pointed out a couple of
4 critical flaws on their face with the Ten Customer Rule and
5 the 70 Percent Rule, and I don't think they've been very
6 well addressed respectfully by Herbalife.

7 One is the ten customer audits -- sorry, the Ten
8 Customer Rule form does not include the names or contact
9 information of the customers; so any audit based on that
10 rule would be, I'll say -- sorry, it could not be an
11 unannounced audit. You would have to get information from
12 the distributor in question in order to conduct your audit.
13 That's undisputed.

14 Also the amount of audits in relationship -- of
15 the Ten Customer Rule in relationship to the amount of
16 distributors is approximately five-one-thousandths of
17 1 percent, and we would submit that that's not sufficient
18 evidence to raise a genuine issue of fact of effectiveness
19 of that rule even if you did have retail sales, which you do
20 not.

21 THE COURT: And how do you get there?

22 MR. STEPHENS: Well, the most compelling, I must
23 say, is not having the retail sales, but I get there by
24 saying if I'm Herbalife and I have to prove that that rule
25 is effective, I have to prove that individuals would be

1 encouraged to sell retail by the Ten Customer Rule. And I
2 just think ten customers per month, which is a one in 19,000
3 chance of being audited, is not sufficient to encourage
4 sales, retail sales.

5 And I would also point out, Your Honor, that that
6 rule, the Ten Customer Rule, applies only to supervisors and
7 above who are receiving royalty payments in that given
8 month.

9 And the evidence in the record from Herbalife's
10 own statistics is that 85 percent of the active leaders
11 within Herbalife receive on average \$444 annually; so the
12 Ten Customer Rule does not really even apply. In other
13 words, a form is not required to be filled out for all of
14 those distributors who are not receiving a royalty payment.
15 And based on the statistics provided by Herbalife that would
16 be a vast number.

17 THE COURT: Counsel says if we look at Koscot and
18 cases that have followed, look at the legislation that
19 exists in the area of endless chain, the concern is that its
20 like musical chairs. At some point you fill up all of the
21 seats and you get to people at the bottom level who are just
22 coming in and there's just nobody left to sell to, there's
23 nothing left to do, you end up with garages full of
24 inventory and so forth; and that Herbalife has been in
25 existence and operated for 30 years without any such event.

1 Doesn't that give some indication, some evidence
2 that it's not operating in the manner that is the principal
3 concern of the endless chain legislation?

4 MR. STEPHENS: No, Your Honor.

5 THE COURT: Why not?

6 MR. STEPHENS: Because the ultimate point of
7 Omnitrition is whether or not retail sales are encouraged,
8 and as you'll -- and inventory loading is deterred. And as
9 the Court pointed out in its original comments because the
10 rewards of Herbalife are not in any way tied to retail sales
11 and they don't keep track of retail sales, it's a pyramid
12 scheme or an endless chain scheme. And the fact that
13 they've been able to perpetuate that scheme for 30 years by
14 itself doesn't raise a genuine issue at all.

15 As I said, even the evidence that's in the record
16 shows that 85 percent of the active leaders, which are our
17 supervisors, get \$440 per year; and so I think that that
18 proves the point of Omnitrition, which is not that it will
19 fail, but that the rewards will go to the people at the top.

20 THE COURT: What if we had the data? Counsel
21 said: Look, if you analyze the data, what you find is that
22 60 percent of the volume of Herbalife is going to people who
23 have signed for up for this distributorship, in essence, to
24 get the discount. I assume to get that kind of volume you'd
25 have to have tens of thousands of people, maybe more, who

1 essentially want to be a part of the organization because
2 they like the product and they want to get it at 25 percent
3 off. If that could be shown, would that undermine your
4 argument and would that put Herbalife within the scope of
5 propriety as defined by Omnitrition and Section 327?

6 MR. STEPHENS: No.

7 THE COURT: No?

8 MR. STEPHENS: Well, first I don't need to say,
9 but we don't have the data, but you're saying -- and you're
10 asking me a hypothetical --

11 THE COURT: Yeah.

12 MR. STEPHENS: -- I appreciate that. The answer,
13 I think, is no for two reasons. No. 1 is the point of
14 Omnitrition is to have the product go into the hands of
15 retail customers, meaning people that are outside the
16 scheme, if I can use that word, or outside the distribution
17 chain --

18 THE COURT: The organization.

19 MR. STEPHENS: The organization.

20 Distributors who receive a 25 percent discount are
21 just as much within the organization as supervisors and
22 above, which receive a 50 percent discount. They are within
23 the organization by virtue of signing a distributorship
24 agreement, which contains all the restraint and all the
25 restrictions, and they have to abide by all the rules. And

1 it's very interesting that I know this to be true because in
2 the Ten Customer Rule that Herbalife purports to have, you
3 could not write down a distributor who gets 25 percent
4 discount as one of your --

5 THE COURT: Retail customers.

6 MR. STEPHENS: -- retail customers. And that I
7 believe, if I'm not mistaken, is in the Jenny Heinrich's
8 declaration and is in the rule itself; so even if we had
9 that data with respect to these 25 percent discount
10 distributors, I don't think that allows Herbalife to
11 circumvent the holding of Omnitrition, which is meant to tie
12 rewards to people within the organization who receive a
13 royalty to their retail sales and there is no such tie here.

14 THE COURT: Omnitrition does say and does have
15 this language which talks about the effectiveness of the
16 rule and rules which purportedly make a multi-level
17 marketing operation proper and lawful.

18 When I read language like "effectiveness," it
19 makes me think that its awfully difficult to summarily
20 adjudicate such a determination and that maybe there's
21 issues for trial that need to be resolved. In particular,
22 the ultimate question, the ultimate fact: Was it effective
23 and exactly how did it work; and shouldn't a jury take a
24 look at how it operates and what the facts are regarding the
25 rules and the enforcement of the rules before we reach a

1 judgment in the case?

2 MR. STEPHENS: I can appreciate that point that
3 you just made, Your Honor, and I think the question was
4 answered again in your initial remarks; and that is to make
5 that evaluation of effectiveness you need empirical data.
6 And that empirical data would rest and the opportunity to
7 collect that data would rest with Herbalife, you see,
8 because they've known about Omnitrition, as we pointed out
9 in our reply brief, for over 14 years.

10 THE COURT: You're not saying they have the
11 burden, are you? Since you raised the claim, the burden of
12 proof is on the counterclaim, isn't it?

13 MR. STEPHENS: Well, Your Honor, we have
14 established under Omnitrition -- Omnitrition basically says
15 that Omnitrition, like Herbalife, which are basically
16 indistinguishable as the Court pointed out, is, on its face,
17 and I don't mean to quote, I'm paraphrasing, but I could
18 quote if I thought it was important, on its face the system
19 appears to be a scheme.

20 Omnitrition, then, as Amway did in 1973, went back
21 and tried to prove that it wasn't a scheme, despite its
22 facial appearance of a scheme, by reference to these three
23 rules. And the Omnitrition court, the Ninth Circuit, very
24 clearly delineated what Omnitrition would have to prove.
25 Okay.

1 Now, that was in 1996 --

2 THE COURT: Well, it didn't say who had the burden
3 of proof. It said: Here's what the evidence would be that
4 we would look to, but it didn't necessarily indicate that in
5 a case like this that it would be their burden in the first
6 instance. I mean, it seems to me that since you have
7 brought the claim --

8 And, by the way, I do want you to address the
9 standing question as well, but since you've brought the
10 claim -- that -- as a counterclaim, that the burden is going
11 to be on the defendants if the case is not summarily
12 adjudicated. If we go to trial, that the burden would be on
13 the defense as counterclaimants to prove that it's an
14 endless chain, and that the evidence -- we know what the
15 evidence is because Omnitrition essentially tells us what we
16 have to look for, but I do think that the burden, if we do
17 get to trial, rests with you as having asserted a claim.

18 MR. STEPHENS: Even if the burden rests with us,
19 Your Honor, if the evidence necessary to meet that burden
20 rests with Herbalife and they don't have that evidence, I
21 don't think that it would be appropriate under Omnitrition
22 or just under basic principles of jurisprudence for a party
23 to be able to not create the evidence that they have the
24 only ability to create, in this case, some empirical data of
25 actual retail sales --

1 THE COURT: No, but that's your case-in-chief.
2 Your case-in-chief is to present to the jury the absence of
3 any data from which then you draw the inference -- right --
4 that the reason that the data isn't collected is because it
5 is insignificant to Herbalife; that's your point, isn't it?

6 MR. STEPHENS: If we go to trial --

7 THE COURT: Look, let's stop this discussion
8 because it's not helpful. I am telling you -- I'm not
9 asking you, I am telling you, in line with traditional
10 jurisprudence, you have the burden of proof; and you will
11 have to -- if we go to trial, if it's not summarily
12 adjudicated, the burden on this issue rests with the party
13 raising the question. That's you.

14 MR. STEPHENS: Okay.

15 THE COURT: So let's talk about the merits,
16 though, of the summary judgment since -- and you've raised
17 summary judgment so, I mean, it's your burden on summary
18 judgment to show that (a), there's no genuine issue of
19 material fact for trial; and (b), that you're entitled to
20 judgment as a matter of law. So that's where we are at this
21 point.

22 But in that regard, you do have an obligation to
23 establish standing. Counsel has thrown in this standing
24 argument.

25 Do you want to address that?

1 MR. STEPHENS: Yes, Your Honor.

2 THE COURT: Okay. Go ahead.

3 MR. STEPHENS: I think we have standing based on
4 two grounds. One, is we've alleged a counterclaim, the
5 intentional interference with prospective economic
6 advantage. And based on that, an endless chain scheme
7 whether -- in Omnitrition, the Omnitrition case itself says
8 a pyramid scheme violates several federal anti-fraud
9 provisions; and also the Penal Code of California,
10 section 327, could satisfy the element of an independent
11 wrong as is articulated in Korea Supply and other cases,
12 such as the Edwards case, to satisfy that element of
13 intentional interference with prospective economic advantage
14 claim.

15 The kind of more intellectually interesting issue
16 is based on some of the cases that have recently come down
17 under UCL, under the unfair competition law, whether there
18 is standing in this case. And our position in this case is
19 that the most instructive authority on that is in the In re
20 Tobacco case, which just came out of the California Supreme
21 Court, coincidentally, on the very day that we were filing
22 our opposition paper. And it's important for two reasons,
23 Your Honor.

24 It's important because if we look at the facts of
25 In re Tobacco, and also if we look at the underlying

1 reasoning of that case -- and it's kind of interesting, I
2 mean, I think the Court was prescient in its decision in
3 denying the motion to dismiss in citing Judge Carter in the
4 White case regarding this standing issue and it beared out
5 with In re Tobacco.

6 No. 1, on the factual point in In re Tobacco, the
7 only standing that the representative class member had was
8 they bought cigarettes. And as a result of buying
9 cigarettes in response to a false advertising claim that was
10 widely dispersed, their health was injured; right? And so
11 based just on standing alone, focusing on standing, the
12 analog here would be our clients, as former Herbalife
13 distributors, purchased Herbalife products and their
14 financial health was injured. So based on that, I think
15 that there's a --

16 THE COURT: But that's not the counterclaim. The
17 counterclaim is different.

18 And, by the way, I'm very familiar with the In re
19 Tobacco, two cases, because it effects practically every
20 consumer class action I've got, every single one of them.
21 And Justice Moreno and the majority first said the question
22 was who has to have standing -- just the named plaintiff.
23 It doesn't have to be every member of the class because it
24 was a class action. And then second point is there has to
25 be injury-in-fact.

1 Now that makes me think about this case, frankly,
2 in a slightly different way than I was thinking about it
3 before the argument, which is maybe -- maybe I have to
4 determine the validity of the prospective advantage claim
5 and the other claims that you've raised before I can make a
6 determination as to whether I can even reach the endless
7 chain scheme because if I consider those claims ultimately
8 to have no merit, the question is whether you can bring an
9 endless chain when you're outside of the organization, when
10 your clients are outside of the organization. And you're
11 saying they can bring it based on the injury-in-fact from
12 their purchase of goods while they were in that
13 organization.

14 MR. STEPHENS: In part. I have another basis of
15 standing, though, that I would like to mention that is, I
16 think, touched upon by the In re Tobacco case. And that is
17 in In re Tobacco case, the California Supreme Court was very
18 careful to indicate that Proposition 64, which was then
19 included in our California Business and Professions Code,
20 was directed toward a very specific abuse and -- we all
21 remember, I assume we were all in California at the time and
22 that the specific abuse was the representative claim that
23 created a -- what the California Supreme Court called
24 "shakedown" lawsuits.

25 THE COURT: Yeah, the use of class actions to

1 extort settlements.

2 MR. STEPHENS: Exactly. And I understand that
3 this is an alternative argument that I'm making, but in
4 addition to having our client be former Herbalife
5 distributors who purchased product and were financially
6 damaged and then left Melaleuca -- now we're at Melaleuca
7 and in that case we are competitors with Herbalife, as
8 Herbalife has, in fact, alleged in its complaint because it
9 has a UCL claim that it's alleged against my clients.

10 Now, because the California Supreme Court was so
11 careful to specify the abuse that 64, Proposition 64 was
12 designed to curb, I think one thing that is clear and one
13 thing that's clear certainly from my memory of that time and
14 the ballot pamphlet as described in In re Tobacco is Prop 64
15 was not about a direct -- restricting the rights of a direct
16 competitor to sue a direct competitor for unfair
17 competition --

18 THE COURT: It's not about unfair competition in
19 that sense at all, it's about fraud. It's about false
20 advertising. And Justice Moreno was extremely careful to
21 say that that's all this rule in this case applies to are
22 those cases brought under the unfair competition law where
23 it's alleged that advertising was false.

24 MR. STEPHENS: Right. And we have alleged, of
25 course, that advertising was false, and we've alleged -- and

1 as the Ninth Circuit points out in *Omnitrition*, an endless
2 chain scheme is a form of false advertising, which would be,
3 in addition to a violation of the other statutes referenced
4 in *Omnitrition*, a violation of 17500 of the California
5 Business and Professions Code.

6 But my point is that Proposition 64 was not
7 designed to curtail lawsuits where a direct competitor is
8 suing a direct competitor for a fraudulent practice because
9 if it were and if restitution was required, money out of
10 pocket or a vested interest that's lost, it would basically
11 cut a wide -- a large percentage -- I can't say every, but a
12 vast percentage of the direct competitor lawsuits because it
13 would be very unusual for a direct competitor to have to
14 show that level of standing and why should they when
15 Proposition 64 was not designed to address those types of
16 lawsuits and standing in those lawsuits; so that's why I
17 think that the focus of the California Supreme Court in
18 really drilling down on what was the purpose of Proposition
19 64 and going as far as looking at the ballot pamphlet, I
20 think, was very instructive for dealing with the standing
21 arguments that have been raised in our case.

22 THE COURT: All right. Any other issues that you
23 want to address?

24 MR. STEPHENS: Yes, there are actually,
25 Your Honor.

1 THE COURT: Then, let's do it quickly because I'm
2 about -- I need to proceed on to other things. So quickly.

3 MR. STEPHENS: Okay. Quickly. I think that
4 the -- I think we've established causation in our record.
5 If that's an issue, I think we have that established by the
6 record. So I'm not sure if that was one of the bases of the
7 judges -- Your Honor's ruling, but I'll refer to the record
8 in that regard.

9 On the issue of 8-A, I believe it does violate
10 16600. Our clients have established through evidence that
11 we've been harmed by that. I appreciate that Your Honor
12 says that 8-A was moot. That was certainly the ruling
13 with -- of the Ninth Circuit with respect to injunctive
14 relief. It has always been my understanding that Herbalife
15 is going to pursue that cause of action based on 8-A to seek
16 damages. I don't believe they have withdrawn that. If they
17 haven't withdrawn it, it's certainly not moot, and I think
18 we should have a ruling on whether 8-A violates 16600. And
19 I think we've thoroughly briefed that, and I believe that it
20 does.

21 Finally on the issue of trade secrets. Your Honor
22 has indicated that trade secrets have been established.
23 Well, we do, in fact, dispute whether or not Herbalife has
24 protectable trade secrets. They have not made a motion to
25 establish that here. So we had a question of whether

1 they've identified their trade secrets properly. If that's
2 an issue that should go to the jury about whether there was
3 a trade secret or whether we, in fact, violated their trade
4 secrets, that's an issue for the jury. I don't even think,
5 quite frankly, it has been raised in the summary judgment
6 motion because had it been raised, we would have brought in
7 a lot of additional evidence, such as the evidence that we
8 brought in in response to the preliminary injunction where
9 the Court did not rule that there had been a violation but
10 simply ruled that there's serious questions about whether
11 there is a violation. So I think if the Court is going to
12 say as a matter of law on this record that we have violated
13 the trade secrets, I have a serious due process concern
14 about that.

15 So, anyway, that's all I have to say.

16 THE COURT: Mr. Patterson, do you want five
17 minutes in reply?

18 Or is Mr. Gates going to speak?

19 MR. GATES: I'll be very quick, Your Honor.

20 17200, 17500 standing, the Tobacco cases don't
21 have anything to do with this case here. Walker is holding.
22 Walker is controlling. The question is whether they need
23 restitution. The fact that they purchased Herbalife
24 products does not give them a claim for restitution. That's
25 not a result of any of the alleged conduct; that's not their

1 claim.

2 One quick thing, I know if you go beyond the
3 mootness of Rule 8-A, one other case that you should take a
4 quick look at, which is in the record, in the brief, is
5 MIA Systems. The Ninth Circuit's holding, on Page 523, the
6 Ninth Circuit upheld summary judgment on behalf and a
7 permanent injunction against the defendants who had violated
8 an employee nonsolicitation provision.

9 The description in the Ninth Circuit case is very
10 brief. You need to go back to the district court opinion
11 and you can read the language of the nonsolicitation
12 provision there. It's a one-year employee nonsolicitation
13 provision.

14 THE COURT: All right. Thank you.

15 Mr. Patterson.

16 MR. PATTERSON: Just very quickly, Your Honor.

17 And that is -- the one thing we can see from these oral
18 arguments is that there is substantial difference on the
19 question of effectiveness and that's what Omnitrition sent
20 the case back to the trial court for, was for a
21 determination by the trial court and question of
22 effectiveness and that has not been shown at this point in
23 time. We say it is effective, they say it is not. There is
24 no evidence from them as to the effectiveness or
25 non-effectiveness.

1 Thank you, Your Honor.

2 MR. JOLLY: Cameron Jolly for the defendants.

3 Can I be heard?

4 THE COURT: On what?

5 MR. JOLLY: On several of the issues relating to
6 my clients. I will be --

7 THE COURT: What issues haven't been addressed at
8 this point?

9 MR. JOLLY: Well, I feel that the issue of the
10 causation of damages on the intentional interference with
11 prospective advantage claims haven't been addressed
12 thoroughly. I think the issue on the record on trade
13 secrets, there's no evidence that Kathy Orr or Jeff Orr or
14 any of the defendants have used the trade secrets of
15 Herbalife. And I think on the issue of mootness, paragraph
16 20 -- 78 of Herbalife's complaint for breach of contract
17 specifically says they're suing us on for the anti --
18 provision, Rule 8-A, pursuant to -- they're seeking damages
19 for Rule 8-A in paragraph 78 of their --

20 THE COURT: Well, that point has been made, and I
21 intend to take a second look at it.

22 MR. JOLLY: Thank you, Your Honor.

23 THE COURT: Have you folks -- I'm afraid I know
24 the answer to this, but have there been any efforts to
25 settle this case?

1 MR. PATTERSON: Yes, Your Honor. There have been.
2 Several.

3 THE COURT: Where do those efforts stand at this
4 point?

5 MR. STEPHENS: Your Honor, we actually had our
6 mediation. Pursuant to the court rules, we chose mediation
7 and we mediated last week with Judge Gary Taylor, and we
8 were not able to come to a settlement.

9 THE COURT: And you're not close?

10 MR. STEPHENS: Not really.

11 THE COURT: You should be. I don't know how much
12 money you folks think is really in this case, but at the end
13 of the day, the biggest number in this case will be the
14 lawyers' fees. I just don't see it as a case where -- we've
15 done preliminary injunctions, we've had stuff come back from
16 the Circuit, we've had this massive set of motions for
17 summary judgment, and I just don't see it as a case where at
18 the end of the day a lot of money is going to change hands
19 no matter what happens in the case, but you folks must see
20 it differently.

21 Who thinks they're going to get a lot of money out
22 of this case?

23 MR. PATTERSON: Not I.

24 THE COURT: It's a very quiet courtroom.

25 MR. PATTERSON: The only thing we can see is a lot

1 of money are the attorneys' fees.

2 MR. JOLLY: Appreciate your comments, Your Honor.

3 THE COURT: Thank you.

4 In recess.

5

6 *(Proceedings were adjourned.)*

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10 CERTIFICATE

11

12 *I hereby certify that pursuant to Section 753,*
13 *Title 28, United States Code, the foregoing is a true and*
14 *correct transcript of the stenographically reported*
15 *proceedings held in the above-entitled matter and that the*
16 *transcript format is in conformance with the regulations of*
17 *the Judicial Conference of the United States.*

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19 *Date: June 2, 2009*

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