

NATURAL HEALTH TRENDS CORP

Form 10-K

May 08, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2005**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number: 0-26272**

**NATURAL HEALTH TRENDS CORP.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

59-2705336  
(I.R.S. Employer  
Identification No.)

2050 Diplomat Drive  
Dallas, Texas  
(Address of principal executive offices)

75234  
(Zip code)

Registrant's telephone number, including area code: (972) 241-4080

Securities registered pursuant to Section 12(b) of the Act:

**None**

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, \$0.001 par value**

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer (as defined in Rule 405 of the Securities Act).

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the

Act. Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (see definitions of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-Accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the closing price of such common equity on June 30, 2005 as reported by the NASDAQ National Market

on that date: \$74,248,760

At April 28, 2006, the number of shares outstanding of the registrant's common stock was 8,199,933 shares.

**Documents Incorporated by Reference**

Certain information required for Part III of this report is incorporated by reference from the registrant's proxy statement for the 2006 annual meeting of the Company's shareholders to be held during the second quarter of 2006.

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Form 10-K  
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Specimen Certificate for Shares of Common Stock

Option Agreement dated as of January 18, 2001

Option Agreement dated as of January 18, 2001

Option Agreement dated as of October 14, 2002

Option Agreement dated as of October 14, 2002

Option Agreement dated as of July 24, 2002

Option Agreement dated as of July 24, 2002

Subsidiaries

Certification of the President Pursuant to Rule 13a-14(a)

Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a)

Certification of the President Pursuant to Rule 13a-14(b)

Certification of the Chief Financial Officer Pursuant to Rule 13a-14(b)

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**FORWARD-LOOKING STATEMENTS**

Certain statements contained in this report constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements included in this report, other than statements of historical facts, regarding our strategy, future operations, financial position, estimated revenues, projected costs, prospects, plans and objectives are forward-looking statements. When used in this report, the words believe, anticipate, intend, estimate, expect, project, could, may, plan, predict, pursue, continue, feel and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words.

We cannot guarantee future results, levels of activity, performance or achievements, and you should not place undue reliance on our forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including the risks described in Risk Factors, and elsewhere in this report. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or strategic investments. In addition, any forward-looking statements represent our expectation only as of the date of this report and should not be relied on as representing our expectations as of any subsequent date. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if our expectations change.

Although we believe that the expectations reflected in any of our forward-looking statements are reasonable, actual results could differ materially from those projected or assumed in any of our forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to change and to inherent risks and uncertainties, such as those disclosed in this report. Important factors that could cause our actual results, performance and achievements, or industry results to differ materially from estimates or projections contained in forward-looking statements include, among others, the following:

- § our relationship with our distributors;
- § our need to continually recruit new distributors;
- § our internal controls and accounting methods may require further modification;
- § adverse consequences from audit committee investigations or management changes;
- § regulatory matters governing our products and network marketing system;
- § regulatory matters pertaining to direct-selling laws, specifically in China;
- § our ability to recruit and maintain key management,
- § adverse publicity associated with our products or direct selling organizations;
- § product liability claims;
- § our reliance on outside manufacturers;
- § risks associated with operating internationally, including foreign exchange risks;
- § product concentration;
- § dependence on increased penetration of existing markets;
- § the competitive nature of our business; and

§ our ability to generate sufficient cash to operate and expand our business.

Market data and other statistical information used throughout this report is based on independent industry publications, government publications, reports by market research firms or other published independent sources and on our good faith estimates, which are derived from our review of internal surveys and independent sources. Although we believe that these sources are reliable, we have not independently verified the information and cannot guarantee its accuracy or completeness.

Additional factors that could cause actual results to differ materially from our forward-looking statements are set forth in this Annual Report on Form 10-K, including under the heading Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations and in our financial statements and the related notes.

Forward-looking statements in this Annual Report on Form 10-K speak only as of the date hereof, and forward looking statements in documents attached are incorporated by reference speak only as of the date of those documents. The Company does not undertake any obligation to update or release any revisions to any forward-looking statement or to report any events or circumstances after the date hereof or to reflect the occurrence of unanticipated events, except as required by law. Unless otherwise noted, the terms we, our, us, Company, refer to Natural Health Trends Corp. and its subsidiaries.

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**PART I**

**Item 1. BUSINESS**

**Overview of Business**

Natural Health Trends Corp. (the Company) is an international direct-selling organization. We control subsidiaries that distribute products through two separate direct-selling businesses that promote health, wellness and vitality.

Lexus International, Inc., our wholly-owned subsidiary (Lexus U.S.), and other Lexus subsidiaries (collectively, Lexus), sell certain personal care, wellness and quality of life products, which accounted for approximately 99% of our consolidated net revenues in 2005. eKaire.com, Inc. (eKaire), our wholly-owned subsidiary, distributes nutritional supplements aimed at general health and wellness.

Lexus commenced operations in January 2001 and has experienced tremendous growth. As of December 31, 2005, it is conducting business in 15 countries through approximately 119,000 active distributors. These statistics do not include the countries and distributors of KGC Networks Pte Ltd. (KGC) as the Company sold its 51% interest in that subsidiary to the minority shareholder effective December 31, 2005 (see Recent Developments). eKaire has been in business since 2000 and is operating in four countries through approximately 3,000 active distributors. We consider a distributor active if he or she has placed at least one product order with us during the preceding year.

We seek to be a leader in the direct selling industry serving the health, wellness and lifestyle marketplace by driving our products into as many venues and into as many markets as possible through our direct selling marketing operations. Our objectives are to enrich the lives of the users of our products and enable our distributors to benefit financially from the sale of our products.

We maintain executive offices at 2050 Diplomat Drive, Dallas, Texas 75234 and our telephone number is (972) 241-4080. The Company's corporate filings can be viewed on its website located at [www.naturalhealthtrends.com](http://www.naturalhealthtrends.com). The information provided on our website should not be considered part of this report.

**Recent Developments**

On February 22, 2005, the Company's common stock began trading on The NASDAQ National Market under the ticker symbol BHIP. Prior to that time, the Company's common stock was quoted on the NASD over-the-counter bulletin board under the symbol NHTC and subsequently NHLC.OB.

During April 2005, the Company launched a new product line, Gourmet Coffee Café, which consists of coffee machines and the related coffee and tea pods, in the North American market. Since the launch, the Company has experienced a high rate of defects and product returns. As a result, the Company has delayed continued sales of our existing inventory of this product and approached the manufacturer for resolution. The manufacturer has agreed to repair all of the machines in our existing inventory and provide discounts on future purchases. The Company is currently planning to re-start the sale of the coffee machines in the second half of 2006.



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On June 1, 2005, the Company held its annual meeting of shareholders. At that time, the Company's reincorporation in the State of Delaware was approved by holders of a majority of the Company's shares of common stock outstanding. On June 29, 2005, the Company re-incorporated in the State of Delaware.

The Company entered into a settlement agreement (the Toyota Agreement) dated August 31, 2005 by and among Toyota Jidosha Kabushiki Kaisha (d/b/a Toyota Motor Corporation), Toyota Motor Sales, U.S.A., Inc. (collectively, the Toyota Entities) and Lexxus U.S., pursuant to which the Toyota Entities agreed to terminate their claims against the Company, and the Company agreed to discontinue use of the Lexxus name and mark and change the name of its Lexxus operations and domain names by June 1, 2006, and sell or otherwise dispose of all product inventory marked with the name Lexxus by December 1, 2006. It is anticipated that, by June 1, 2006, the Company will change the name of Lexxus U.S. to NHT Global, Inc. and the terms Lexxus and Lexxus International will be replaced in all other uses by the Company and its subsidiaries by the terms NHT Global or a variation that includes NHT or Natural Health Trends.

During September 2005, the Company reorganized its senior management team in connection with an investigation conducted by the Company's Audit Committee. Effective October 3, 2005, each of Mark Woodburn and Terry LaCore resigned as officers and members of the Company's Board of Directors due to their failure to cooperate with the Audit Committee's investigation. The investigation was initiated in August 2005 and included allegations of misconduct by Messrs. Woodburn and LaCore asserted by an unrelated third party arising out of a lawsuit involving Mr. LaCore and such unrelated third party. From October 3, 2005 through November 13, 2005, Messrs. Woodburn and LaCore were employed as the Company's Global Managing Director Operations and Global Managing Director Business Development, respectively.

Effective October 3, 2005, the Board of Directors of the Company appointed Robert H. Hesse, a member of the Company's Board of Directors since July 2004, as the Company's Interim Chief Executive Officer. The Company also created the Office of the Chief Executive, comprised of Mr. Hesse, Chris Sharng, the Company's Executive Vice President and Chief Financial Officer, and Richard S. Johnson, President of Natural Health Trends Japan, Inc. (NHT Japan). The Office of the Chief Executive was responsible for managing the day-to-day operations of the Company. Since Mr. Hesse was no longer considered to be an independent director, he resigned from the Company's Audit Committee in September 2005.

On November 10, 2005, an independent investigator retained by the Company's Audit Committee learned that an entity controlled by Messrs. Woodburn and LaCore received payments from an independent distributor of the Company's products during 2001 through August 2005. The Company believes that Messrs. Woodburn and LaCore received from such independent distributor a total of approximately \$1.4 million and \$1.1 million, respectively. The Company believes that the fees paid by the Company to such independent distributor were not in excess of the amounts due under the Company's regular distributor compensation plan. The Audit Committee's investigation is continuing (see Item 1A. Risk Factors).

Approximately \$2.4 million of the funds paid by the independent distributor to Messrs. Woodburn and LaCore were paid at the direction of Messrs. Woodburn and LaCore to an entity that is partially owned by Mr. Woodburn's father and Randall A. Mason, a member of the Company's Board of Directors and former Chairman of the Company's Audit Committee. The funds were subsequently paid to an entity controlled by Messrs. Woodburn and LaCore at their direction. After investigation by the Audit Committee, the Board of Directors of the Company concluded that Mr. Mason was unaware that these payments were directed by Messrs. Woodburn and LaCore to an entity partially owned by him until uncovered by the Audit Committee's independent investigator on November 10, 2005, and that Mr. Mason was not involved in any misconduct and received no pecuniary benefit from the payments made by the independent distributor. However, since payments were directed into an entity that is partially owned by Mr. Mason, he could no longer be considered independent in accordance with the rules of The NASDAQ Stock Market and under the federal securities laws. Therefore, effective November 11, 2005, Mr. Mason resigned as Chairman and a member of the Company's Audit Committee. Mr. Mason remained as a director.

On November 14, 2005, in light of the information learned by the Company's Audit Committee on November 10, 2005, the Company terminated the employment of each of Messrs. Woodburn and LaCore. No severance was paid by the Company to Messrs. Woodburn and LaCore and the Audit Committee is investigating claims or actions that the

Company may bring against them.

In addition, a loan made by the Company under the direction of Mr. Woodburn in the aggregate principal amount of \$256,000 in February 2004 was previously recorded as a loan to a third party. On November 10, 2005, the Audit Committee investigator learned that the Company actually loaned the funds to an entity owned and controlled by the parents of Mr. Woodburn. The loan was repaid in full, partially by an entity controlled by a third party and partially by an entity controlled by Mr. Woodburn in December 2004.

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On December 7, 2005, the Board of Directors expanded to six members and Anthony B. Martino, Terrence M. Morris, and Colin J. O'Brien were appointed to join Sir Brian Wolfson (Chairman), Randall A. Mason, and Robert H. Hesse as members of the Company's Board of Directors. At that time, the Board of Directors also appointed the following individuals as sole members of the following committees:

Audit Committee	Compensation Committee	Nominating Committee
Anthony B. Martino (Chairman)	Colin J. O'Brien (Chairman)	Sir Brian Wolfson (Chairman)
Colin J. O'Brien	Terrence M. Morris	Terrence M. Morris
Terrence M. Morris		

Effective December 31, 2005, the Company entered into a Stock Purchase Agreement with Bannks Foundation, a Lichtenstein foundation and owner of 49% of the common shares of KGC, a Singapore corporation, pursuant to which the Company sold to Bannks Foundation 51,000 common shares representing the Company's 51% of the outstanding shares of capital stock of KGC for a total cash purchase price of \$350,000. KGC was a Company subsidiary through which the Company's Lexxus products were sold into a separate network of independent distributors located primarily in Russia and other Eastern European countries. In connection with the sale of its interest in KGC, the Company entered into a separate agreement with KGC providing for the payment to the Company of 24 equal monthly installments of approximately \$169,000 each relating to inventories ordered and partially delivered, and the settlement of its outstanding inter-company receivable. The Company also agreed to continue to supply KGC with certain products for a period of at least 48 months. As a result of these transactions, the Company will no longer include the financial statements of KGC in its consolidated financial statements. The Company does not believe these transactions result in a discontinued operation as the Company will continue to supply KGC with a significant amount of product for the foreseeable future. Therefore, the 2005 results of KGC have been reported in results from operations.

On February 10, 2006, the Company entered into an Escrow Agreement (the "Agreement") with Messrs. Woodburn and LaCore, the LaCore and Woodburn Partnership, an affiliate of Woodburn and LaCore, and Krage and Janvey LLP, as escrow agent (the "Agent"). Pursuant to the Agreement, (i) the Company agreed to issue and deposit with the Agent stock certificates in the name of the Agent representing an aggregate of 1,081,066 shares of the Company's common stock (the "Escrowed Shares") and (ii) Woodburn and LaCore deposited with the Agent \$1,206,000 in immediately available funds (the "Cash Deposit"). The Escrowed Shares are the shares of common stock issuable upon the cashless exercise of options issued in 2001 and 2002 to LaCore and the LaCore and Woodburn Partnership for 1,200,000 shares of common stock exercisable at \$1.00 and \$1.10 per share. The number of Escrow Shares is based upon the closing price of the Company's common stock on February 9, 2006 of \$10.14 and the surrender of 118,934 option shares as payment of the aggregate exercise price of \$1,206,000.

The Escrowed Shares were issued pursuant to Section 4(2) of the Securities Act of 1933, as amended, to the Agent upon receipt from the Agent of an irrevocable proxy (the "Proxy") to the Company to vote the Escrowed Shares on all matters presented at meetings of stockholders or any written consent executed in lieu thereof. The parties have agreed that the Agent will hold the Escrowed Shares and the Cash Deposit until it receives (i) joint written instructions from the Company, Woodburn and LaCore, or (ii) a final non-appealable order from a court of competent jurisdiction. Each of the Company and Woodburn and LaCore has further agreed that all current and future rights, claims, defenses and causes of actions they have or may have against each other are preserved.

On March 10, 2006, the Company entered into a letter agreement dated March 1, 2006 with Robert H. Hesse, the Company's Interim Chief Executive Officer and a member of the Board of Directors. Pursuant to the letter agreement, Mr. Hesse has agreed to continue acting as the interim chief executive officer of the Company. In addition to continuing his base pay of \$2,000 per day, the Company has agreed to pay Mr. Hesse a retention bonus equal to \$300,000, of which \$150,000 is due and payable upon executing the letter agreement and \$150,000 is due within five days after satisfactory completion of Mr. Hesse's term as Interim Chief Executive Officer.

On March 16, 2006, Richard S. Johnson, the Company and NHT Japan amended Mr. Johnson's employment agreement effective as of February 1, 2006. As amended, the employment agreement is extended through January 31, 2009. Under the amended employment agreement, Mr. Johnson will continue to serve as President of NHT Japan and will provide advice and services to the Company, as requested. For health reasons, Mr. Johnson will reside in the U.S.

and is expected to work a reduced number of hours. He will be compensated by the Company under the amended employment agreement at the rate of \$2,000 per day with a minimum of \$16,000 per quarter (or \$64,000 per year). Under the amended employment agreement, the Company will issue to Mr. Johnson options

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exercisable for 8,000 shares of the Company's common stock during each year of the term of the consulting agreement. The options shall be exercisable at a price equal to the fair market value of the shares of common stock on the date of grant and will be issued pursuant to the Company's 2002 Stock Plan. The Company has also agreed to reimburse Mr. Johnson for business related expenses.

On March 28, 2006, the Board of Directors and Mr. Hesse mutually agreed that Mr. Hesse had completed his assignment as the Interim Chief Executive Officer of the Company, effective immediately. In addition, as of March 28, 2006, the Board of Directors promoted Curtis E. Broome from President-Greater China and Southeast Asia to the position of President of NHT Global designate Mr. Broome to serve as the Company's principal executive officer on an interim basis. The Search Committee of the Board of Directors continues to conduct an active search for a chief executive officer.

Also effective March 28, 2006, the Board of Directors terminated the Office of the Chief Executive and formed an Executive Management Committee (the "EMC") that consists of Mr. Broome, Mr. Sharnq, and John Cavanaugh, the President of the Company's MarketVision subsidiary. Terrence M. Morris, a member of the Company's Board of Directors, will have the right to attend all meetings of the EMC and will liaise with the Board of Directors regarding matters addressed by the EMC. The EMC will manage the Company's day-to-day operations and will report directly to the Board of Directors. In the event that the Board of Directors determines that continued participation with the EMC would interfere with Mr. Morris' exercise of independent judgment in carrying out his responsibilities as a director, Mr. Morris may be asked to refrain from participating in EMC matters in order to preserve his status as an independent director on the Board. As compensation for Mr. Morris' additional tasks, a monthly payment of \$4,000 has been approved by the Board of Directors.

Additionally, on March 28, 2006, Sir Brian Wolfson decided, for personal reasons, to resign as Chairman of the Board of Directors and will continue to serve as its Vice Chairman. In connection therewith, the Board of Directors appointed Randall A. Mason, a member of the Board of Directors since May 2003, as its Chairman.

On April 6, 2006, a mutual agreement was entered into with two members of the Company's Mexico management team, Oscar De la Mora and Jose Raul Villareal, terminating the employment of Messrs. De la Mora and Villareal and all employment agreements between them and affiliates of the Company. Messrs. De la Mora and Villareal may, in the future, serve as independent distributors for the Company and its affiliates.

On April 18, 2006, the Company received a letter from The NASDAQ Stock Market stating that the Company is not in compliance with Marketplace Rule 4310(c)(14), which obligates listed issuers to timely file those reports and other documents required to be filed with the Securities and Exchange Commission. On April 25, 2006, the Company requested a hearing with the NASDAQ Hearings Panel concerning the Company's failure to file its Form 10-K in a timely fashion. The Company received a hearing date of June 1, 2006 from NASDAQ. The Company has been advised that its shares of common stock will not be delisted prior to the date of the hearing.

On April 20, 2006, the Board of Directors accepted Mr. Broome's request to resign as the Company's interim principal executive officer and appointed Mr. Sharnq as the interim principal executive officer.

On May 5, 2006, the Company paid \$150,000 to Mr. Hesse as provided in the above letter agreement dated as of March 1, 2006, that was signed on March 10, 2006. Mr. Hesse has released the Company from all other obligations under that letter agreement and, effective May 5, 2006, resigned from the Company's Board of Directors.

### **Our Principal Products**

We offer several Lexus branded products, which principally include:

*Skindulgence*<sup>®</sup> is a skin care system that includes a 30-Minute Non-Surgical FaceLift as well as a spa collection for hands, feet and all-over body. The 30-Minute Non-Surgical FaceLift is designed to create a more youthful appearance by helping to tone and firm facial muscles, by helping to diminish fine lines and wrinkles and by helping to improve skin tone and color. The facelift masque is coupled with a cleanser and moisturizer.

*Alura*<sup>®</sup> is an intimacy enhancing cream for women.

*Valura Xtreme* is an intimacy enhancing herbal supplement for men that will be offered for sale in 2006 to replace the *Valura* product previously offered for sale.



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*Premium Noni Juice* is a reconstituted morinda citrifolia fruit juice, made from organic noni puree. Noni is a fruit native in the Samoan Islands of the South Pacific. Marketed as a refreshing and energizing beverage, its natural flavor has been enhanced with white grape concentrate, concord grape concentrate, pineapple juice puree and other natural flavors.

*LexLips* is a lip enhancing gloss designed to create the effect of fuller lips and to help reduce fine lines and wrinkles around the mouth.

*La Vie* is an energy-boosting dietary supplement described as a non-alcoholic red wine.

*180° Life System*<sup>®</sup> - Carb Blocker is a weight management product.

*Triotein* is a lactose-free whey protein powder that provides amino acid substrates needed to stimulate the body's production of an anti-oxidant, intracellular glutathione peroxidase, in an effort to optimize the body's ability to heal itself.

*Cluster Concentrate* is a product created for increased and more efficient cell hydration.

We offer Kaire branded products, generally nutritional supplements, which are organized into several broad categories such as antioxidant support, immune support, bone & joint support, digestive and dietary support, weight management, OmegaKaire hemp products, Sakaira Spa with Moor Mud, Sakaira Skin & Hair Care, Kaire Essentials and ecoKaire Home Care. Among the products offered by eKaire, *Pycnogenol*<sup>®</sup>, *Enzogenol*, *OptiMSM*, *OptiPhyto*, *Phase2* & *ActivAloe* are trademarks of our suppliers.

## **Operations of the Business**

### **Sourcing of Products**

The Company's independent research consultants and the executive staff work with research and development personnel of our manufacturers to create product concepts and develop the product ideas into actual products. Each of the Company's three current major product lines *Skindulgence*<sup>®</sup>, *Alura*<sup>®</sup> and *Premium Noni Juice* - were originally conceived by our manufacturing vendors. The Company or its subsidiaries then enter into supply agreements with the vendors pursuant to which the Company obtains exclusive rights to sell the products under private labels (or trademarks) that are owned by the Company. Because our current main products all came to us originally as proposals from our vendors, we have incurred minimal out-of-pocket research and development costs through December 31, 2005.

The Company or its subsidiaries generally purchase finished goods from manufacturers and sells them to our distributors for their resale or personal consumption. Aloe Commodities International (for *Skindulgence*<sup>®</sup>), 40Js LLC (for *Alura*<sup>®</sup>) and Two Harbor Trading (for *Premium Noni Juice*) are the three most significant vendors, accounting for a majority of the Company's product purchases. The Company is required to purchase from 40Js LLC a minimum volume of 15 barrels of product per quarter to maintain the exclusivity and volume discount rights granted in the agreement. The terms of these agreements are between one and three years, with annual automatic renewal. We believe that, in the event we are unable to source products from these suppliers or the other suppliers of our other products, our revenue, income and cash flow could be adversely and materially impacted.

### **Marketing and Distribution**

Lexus and eKaire are set up as direct-selling companies using separate networks of distributors to sell products. Our distributors are independent full-time or part-time contractors who purchase products directly from our subsidiaries via the Internet for resale to retail consumers (other than in China) or for their own personal consumption. Purchasers of our products in China may purchase only for their own personal consumption and not for resale in China. The growth of a distributor's business depends largely upon their ability to recruit a down-line network of distributors and the popularity of our products in the marketplace.

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As of December 31, 2005, we had an active physical presence in eight (the U.S., Mexico, South Korea, Japan, Taiwan, China, Australia and Canada) of the top 15 direct-selling markets in the world. We experienced a 33% increase in active Lexxus distributors during 2005, following a 97% increase in active distributors in 2004 compared to the prior year (excluding KGC distributors). The following table represents the number of active distributors by market for both Lexxus and eKaire as of December 31.

	Year Ended December 31,		
	2003	2004	2005
United States	5,295	8,876	7,309
Canada	1,793	4,020	4,662
North America	7,088	12,896	11,971
Hong Kong	28,971	63,114	86,661
Taiwan	2,323	2,533	2,873
Greater China	31,294	65,647	89,534
Singapore	797	735	527
Philippines	1,139	2,799	341
Southeast Asia	1,936	3,534	868
Australia	214	374	710
New Zealand	34	32	75
Australia/NZ	248	406	785
Russia and Eastern Europe <sup>1</sup>	26,775	40,727	52,679
South Korea	3,510	4,780	6,257
Latin America	192	87	1,456
Central Europe		891	1,895
Japan		848	5,947
India	883	25	
Total Lexxus distributors	71,916	129,841	171,392
Less KGC <sup>1</sup>	(26,775)	(40,727)	(52,679)
Total Lexxus distributors without KGC	45,151	89,114	118,713
eKaire	4,671	3,656	3,008
Total distributors	49,822	92,770	121,721

We devoted much time and resources to pursue opening the Japanese, Mexican and Chinese markets in 2005. We commenced revenue generation in Mexico and Japan in the fourth quarter of 2005. We have submitted an application for a direct selling license in China in December 2005.

To become a Lexxus or eKaire distributor, a prospective distributor must agree to the terms and conditions of our distributor agreement (posted on our respective Lexxus or eKaire website). Lexxus distributors generally pay a nominal \$100 annual enrollment fee. The distributor agreement sets forth our policies and procedures, and we may



elect to terminate a distributor for non-compliance.

- <sup>1</sup> The Company will no longer consolidate the operating results of KGC for periods beginning after December 31, 2005 as it sold its 51% equity interest to Bannks Foundation effective December 31, 2005.

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We pay commissions to eligible Lexxus distributors based on sales by such distributors down-line distributors during a given commission period. To be eligible to receive commissions, distributors in some countries may be required to make nominal monthly purchases of products. We believe that the uniqueness and efficacy of our Lexxus products, combined with a high commission rate, creates a highly desirable business opportunity and work environment for our Lexxus distributors. See Working with Distributors.

Distributors generally place orders through their own Internet page and pay by credit card prior to shipment. Accordingly, we carry minimal accounts receivable and credit losses are historically minimal.

We regularly sponsor promotional meetings and participate in motivational training events in key cities around the world for Lexxus distributors. These events are designed to inform prospective and existing distributors about both existing and new product lines as well as selling techniques. Distributors typically share their direct selling experiences, their individual selling styles and their recruiting methods at these promotional or training events. Prospective distributors are educated about the structure, dynamics and benefits of the direct selling industry. We are continually developing or updating our marketing strategies and programs to motivate our distributors. These programs are designed to increase distributors monthly product sales and the recruiting of new distributors in their down-lines.

**Management Information Systems**

The Lexxus business uses our proprietary web-based MarketVision system to process orders and to communicate volume and commissions to distributors. KGC, a majority owned subsidiary until December 31, 2005, used a third-party service provider, Septuor Consulting, and its software for functionalities similar to those provided by MarketVision (see Recent Developments ). The Kaire business uses a third-party software package, Infotrax, to calculate commissions and provide each independent distributor with a detailed monthly accounting of all sales and recruiting activity. These statements eliminate the need for substantial record keeping on behalf of the distributor.

Other than MarketVision, the Company has not automated and integrated other critical business processes such as inventory management and accounting. The Company began automating the financial reporting processes with Oracle s E-Business Suite in the fourth quarter of 2005 and expects to continue this process for the first half of 2006.

**Corporate History**

The Company s current business can be traced back to Kaire Neutraceutical Inc., a privately owned Colorado company involved in direct selling. Mr. Mark Woodburn was engaged by its investors as an advisor and subsequently became the President in 1999. Mr. Woodburn engaged Mr. Terry LaCore as a direct selling consultant to turn around the struggling business. Mr. Woodburn assisted with its acquisition of the Company, which was an inactive publicly traded entity originally incorporated in Florida in 1988, and reverse-merged Kaire Neutraceutical Inc. into the Company in 1999. In 2000, Kaire Neutraceutical Inc. was sold to certain private investors. Also in 2000, the Company was relocated to Dallas, Texas.

In January 2001, the Company with certain minority investors launched the Lexxus business in the U.S. The move was followed by a string of international expansions of the Lexxus business that significantly fueled the growth of the Company. On March 31, 2004, the Company acquired MarketVision Communications Corp. ( MarketVision ), the exclusive provider of the direct selling software used by our Lexxus businesses around the world since mid-2001. Effective June 29, 2005, the Company changed its state of incorporation from Florida to Delaware.

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### **Geographic Locations**

The Company operates in 15 countries. The Company's business is generally organized along geographic lines within the two different brands:

Lexxus has active physical presence in the following markets:

- o North America (United States and Canada)
  
- o Greater China (Hong Kong, Macau, Taiwan and China) and Southeast Asia (Singapore, the Philippines and Indonesia)
  
- o Australia and New Zealand
  
- o South Korea
  
- o Japan
  
- o Latin America (primarily Mexico)
  
- o Slovenia

eKaire has active physical presence in the following markets:

- o North America (United States and Canada)

- o Australia and New Zealand

Natural Health Trends Corp. is headquartered and mainly staffed in Dallas, Texas.

MarketVision is staffed in Minneapolis, Minnesota.

Until December 31, 2005, the Company owned a 51% interest in KGC, which has a physical presence in Russia and Eastern Europe.

See Item 2. Properties for specific locations of our facilities.

### **Employees**

At December 31, 2005, the combined total number of world-wide employees for our company was 222, of which the United States had 54 employees, Cayman Islands 1, Canada 11, Hong Kong and China 73, Taiwan 26, the Philippines 1, Singapore 4, Indonesia 5, South Korea 17, Mexico 9, Japan 15, and Australia 6. The number of employees is expected to increase in the coming year, especially in China, where we anticipate using employees rather than independent distributors to market and sell our products.

### **Seasonality**

Our revenue has generally not been impacted by seasonality on any significant basis. From quarter to quarter, the Company is somewhat impacted by seasonal factors and trends such as major cultural events and vacation patterns. For example, most Asian markets celebrate their respective local New Year in the first quarter, which generally has a small negative impact on that quarter. We believe that direct selling in the United States and Europe is also generally negatively impacted during the month of August, which is in our third quarter, when many individuals, including our distributors, traditionally take time off for vacations.

### **Intellectual Property**

Most of the Lexxus and eKaire products are packaged under a private label arrangement. We have applied for trademark registration for names, logos and various product names in several countries into which Lexxus and eKaire are doing business or considering expanding into. We currently have three trademark registrations in the United States. Our registered trademarks expire or become renewable in 2007 and 2008, and we rely on common law trademark rights to protect our unregistered trademarks. These common law trademark rights do not provide us with the same level of protection as afforded by a United States federal registration trademark. Common law trademark

rights are limited to the geographic area in which the trademark is actually utilized, while a United States federal registration of a trademark enables the registrant to discontinue the unauthorized use of the trademark by a third party anywhere in the United States even if the registrant has never used the trademark in the geographic area where the trademark is

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being used, provided, however, that the unauthorized third party user has not, prior to the registration date, perfected its common law rights in the trademark within that geographic area.

In November 2001, the inventor of our *Alura*<sup>®</sup> product, from whom we have a license to distribute *Alura*<sup>®</sup>, was awarded a patent for the formulation of that product.

As a result of a settlement agreement with Toyota Motor Sales, U.S.A. (see Item 3. Legal Proceedings ), it is anticipated that, by June 1, 2006, the Company will change the name of Lexxus International to NHT Global, Inc. and the terms Lexxus and Lexxus International will be replaced in all other uses by the Company and its subsidiaries by the terms NHT Global or a variation that includes NHT or Natural Health Trends . In connection with this name change, the Company anticipates applying for registration of rights in these names and related marks in various of the countries in which we do business.

In 2005, the Company implemented a foreign holding and operating company structure for our non-United States businesses, which involved the division of our United States and non-United States operations. As part of implementing this structure, the Company and some of its United States subsidiaries granted an exclusive license to some of the Company's non-United States subsidiaries to use outside of the United States all of their intangible property, including trademarks, trade secrets and other proprietary information. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### **Insurance**

The Company currently carries general liability insurance in the amount of \$1,000,000 per occurrence and \$2,000,000 in the aggregate as well as customary cargo and other insurance coverage, including coverage for international subsidiaries. We do not carry product liability insurance, but may be covered by the insurance maintained by our principal suppliers. There can be no assurance, however, that product liability insurance would be available, and if available, that it would be sufficient to cover potential claims or that an adequate level of coverage would be available in the future at a reasonable cost, if at all. A successful product liability claim could have a material adverse effect on our business, financial condition and results of operations. In November 2004, Dorothy Porter filed a complaint against the Company for strict liability, breach of warranty and negligence in the U.S. District Court for the Southern District of Illinois, alleging that she sustained a brain hemorrhage after taking Formula One, an ephedra-containing product marketed by Kaire Neutraceutical Inc., a former subsidiary of the Company (see Item 3. Legal Proceedings ).

### **Working with Distributors**

#### **Sponsorship**

Sponsoring of new distributors creates multiple levels in the direct-selling structure of Lexxus. The persons that a distributor sponsors within the network are referred to as sponsored distributors. Persons newly recruited are assigned by distributors into network positions that can be under other distributors, thus they can be called down-line distributors. If down-line distributors also sponsor new distributors, they create additional levels within the structure, but their down-line distributors remain in the same down-line network as their original sponsoring distributor.

We rely on our distributors to recruit and sponsor new distributors. Our top up-line distributors tend to focus on building their network of down-line distributors. While we provide product samples, brochures and other sales materials, distributors are primarily responsible for recruiting and educating their new distributors with respect to products, the compensation plan and how to build a successful distributorship network.

Distributors are not required to sponsor other distributors as their down-line, and we do not pay any commissions for sponsoring new distributors. However, because of the financial incentives provided to those who succeed in building a distributor network that consumes and resells products, we believe that many of our distributors attempt, with varying degrees of effort and success, to sponsor additional distributors. Because they are seeking new opportunities for income, people are often attracted to become distributors after using our products or after attending introductory seminars. Once a person becomes a distributor, he or she is able to purchase products directly from us at wholesale prices via the Internet. The distributor is also entitled to sponsor other distributors in order to build a network of distributors and product users.

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### Compensation Plans

Lexxus employs what is commonly referred to as a binary compensation plan. We believe that one of our key competitive advantages within the direct selling industry is our compensation plan for Lexxus distributors. Under the Lexxus compensation plan, distributors are paid weekly commissions in the distributor's home country, in their local currency, for product sold by that distributor's down-line distributor network across all geographic markets. Distributors are not paid commissions on purchases or sales of our products made directly by them, but instead earn a spread between the wholesale price to the distributor and the retail price received by the distributor. This seamless compensation plan enables a distributor located in one country to sponsor other distributors located in other countries where we are authorized to do business.

Currently, there are two fundamental ways in which Lexxus distributors can earn income:

Through retail markups on sales of products purchased by distributors at wholesale prices; and

Through a series of commissions paid on product purchases made by their down-line distributors.

Each of our products carries a specified number of sales volume points, also called bonus volume or "BV". Commissions are based on total personal and group sales volume points per sales period. Sales volume points are essentially based upon a percentage of a product's wholesale cost. As the distributor's business expands from successfully sponsoring other distributors who in turn expand their own businesses by sponsoring other distributors, the distributor receives higher commissions from purchases made by an expanding down-line network. To be eligible to receive commissions, a distributor may be required to make nominal monthly purchases of our products. Certain of our subsidiaries do not require these nominal purchases for a distributor to be eligible to receive commissions. In determining commissions, the number of levels of down-line distributors included within the distributor's commissionable group increases as the number of distributorships directly below the distributor increases. Under our current compensation plan, commissions may be limited to 60% of sales. In some markets, commissions may be further limited. From time to time we make modifications and enhancements to our compensation plan to help motivate distributors, which can have an impact on distributor commissions. From time to time we also enter into agreements for business or market development, which may result in additional compensation to specific distributors.

### Distributor Support

We are committed to providing a high level of support services tailored to the needs of our distributors in each marketplace we are serving. We attempt to meet the needs and build the loyalty of distributors by providing personalized distributor services and by maintaining a generous product return policy (see "Product Warranties and Returns"). Because many of our distributors are working on a part-time basis and have only a limited number of hours each week to concentrate on their business, we believe that maximizing a distributor's efforts by providing effective distributor support has been, and could continue to be, important to our success.

Through training meetings, annual conventions, web-based messages, distributor focus groups, regular telephone conference calls and other personal contacts with distributors, we seek to understand and satisfy the needs of our distributors. Via our websites, we provide product fulfillment and tracking services that result in user-friendly and timely product distribution. Most of our offices maintain meeting rooms, which our distributors may utilize for training and sponsoring activities.

To help maintain communication with our distributors, we offer the following support programs:

*Teleconferences.* Lexxus and eKaire hold teleconferences with company management and associate field leadership on various subjects such as technical product discussions, distributor organization building and management techniques.

*Internet.* We maintain our main website at [www.naturalhealthtrends.com](http://www.naturalhealthtrends.com). On this website, the user can read company news, learn more about various products, sign up to be a distributor, place orders, and track the fulfillment and delivery of their order.

*Product Literature.* We offer a variety of literature to distributors, including product catalogs, informational brochures, pamphlets and posters for individual products.

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*Toll Free Access.* eKaire offers a toll free number to place orders and to sponsor new distributors. Lexxus offers these services only through its websites. Both eKaire and Lexxus offer live consumer support where a customer service representative can address general questions or concerns.

*Broadcast E-mail.* Announcements about Lexxus and eKaire are sent via e-mail to all active distributors.

### **Technology and Internet Initiatives**

We believe that the Internet has become increasingly important to our business as more consumers communicate online and purchase products over the Internet as opposed to traditional retail and direct sales channels. As a result, we have committed significant resources to our e-commerce capabilities and the abilities of our distributors to take advantage of the Internet. Substantially all of our sales have occurred via the Internet. eKaire has a personalized website for its distributors to purchase products via the Internet. Lexxus offers a global web page that allows a distributor to have a personalized website through which he or she can sell products in all of the countries in which we do business. Links to these websites can be found at our main website at [www.naturalhealthtrends.com](http://www.naturalhealthtrends.com). The information provided on these websites should not be considered part of this report.

### **Rules Affecting Distributors**

Our distributor policies and procedures establish the rules that distributors must follow in each country. We also monitor distributor activity in an attempt to provide our distributors with a level playing field so that one distributor may not be disadvantaged by the activities of another. We require our distributors to present products and business opportunities in an ethical and professional manner. Distributors further agree that their presentations to customers must be consistent with, and limited to, the product claims and representations made in our literature.

We require that we produce or pre-approve all sales aids used by distributors such as videotapes, audiotapes, brochures and promotional clothing. Further, distributors may not use any form of media advertising to promote products unless it is pre-approved by the Company. Products may be promoted only by personal contact or by literature produced or approved by us. Distributors are not entitled to use our trademarks or other intellectual property without our prior consent.

Our compliance department reviews reports of alleged distributor misbehavior. If we determine that a distributor has violated our distributor policies or procedures, we may terminate the distributor's rights completely. Alternatively, we may impose sanctions, such as warnings, probation, withdrawal or denial of an award, suspension of privileges of the distributorship, fines, withholding commissions, until specified conditions are satisfied or other appropriate injunctive relief. Our distributors are independent contractors, not employees, and may act independently of us. Further, our distributors may resign or terminate their distributorship at any time without notice. See Item 1A Risk Factors Although Our Distributors Are Independent Contractors, Improper Distributor Actions That Violate Laws or Regulations Could Harm Our Business.

## **Government Regulations**

### **Government Regulation of Direct Selling Activities**

Direct selling activities are regulated by various federal, state and local governmental agencies in the United States and foreign countries. These laws and regulations are generally intended to prevent fraudulent or deceptive schemes often referred to as pyramid schemes, that compensate participants for recruiting additional participants irrespective of product sales, use high pressure recruiting methods and/or do not involve legitimate products. The laws and regulations in our current markets often:

impose cancellation/product return, inventory buy backs and cooling off rights for consumers and distributors;

require us or our distributors to register with governmental agencies;

impose reporting requirements; and

impose upon us requirements, such as requiring distributors to maintain levels of retail sales to qualify to receive commissions, to ensure that distributors are being compensated for sales of products and not for recruiting new distributors.

The laws and regulations governing direct selling are modified from time to time to address concern of regulators. For example, in South Korea, regulations were adopted that, among other things, restrict direct selling marketing companies from imposing certain personal sales quota to obtain or maintain distributorship or favorable compensation rates, modify product return requirements so that product must be returned within a shorter period of time, and require the companies to show sufficient insurance or guarantee to



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reimburse customers and/or distributors for cancelled or unfilled orders. We have had to make some modifications to our compensation plan and policies in order to be in compliance with all of these rules.

Based on research conducted in opening our existing markets, the nature and scope of inquiries from government regulatory authorities, and our history of operations in such markets to date, we believe that our methods of distribution are in compliance in all material respects with the laws and regulations relating to direct selling activities of the countries in which we currently operate. Many countries currently still have laws in place that would prohibit us from conducting business in such markets. There can be no assurance that we would be allowed to continue to conduct business in each of our existing markets that we currently service or any new market we may enter in the future.

**Regulation of Our Products**

Our products and related promotional and marketing activities are subject to extensive governmental regulation by numerous domestic and foreign governmental agencies and authorities, including the FDA, the FTC, the Consumer Product Safety Commission, the United States Department of Agriculture, state attorneys general and other state regulatory agencies, and similar government agencies in each country in which we operate. For example, in Taiwan, all medicated cosmetic and pharmaceutical products require registration. These regulations can limit our ability to import products into new markets and can delay introductions of new products into existing markets as we comply with the registration and approval process for our products.

During the fall of 2003, the customs agency of the government of South Korea brought a charge against LXX, Ltd. ( LXX ), the Company's wholly owned subsidiary operating in South Korea, with respect to the importation of the Company's *Alura*® product. The customs agency alleges that *Alura*® is not a cosmetic product, but rather should be categorized and imported as a pharmaceutical product. This allegation prevailed in a Seoul district court ruling in February 2005. In the verdict, the Company was fined and prohibited from marketing *Alura*®. The Company is currently appealing against the Seoul district court ruling. See Item 3. Legal Proceedings.

Some of our products are strictly regulated in certain markets in which we operate. These markets have varied regulations that apply to and distinguish nutritional health supplements from drugs or pharmaceutical products. For example, the FDA of the United States under the Federal Food, Drug and Cosmetic Act regulates our products. The Federal Food, Drug and Cosmetic Act has been amended several times with respect to nutritional supplements, most recently by the Nutrition Labeling and Education Act and the Dietary Supplement Health and Education Act. The Dietary Supplement Health and Education Act establishes rules for determining whether a product is a dietary supplement. Under this statute, dietary supplements are regulated more like foods than drugs, are not subject to the food additive provisions of the law, and are generally not required to obtain regulatory approval prior to being introduced to the market. None of this limits, however, the FDA's power to remove an unsafe substance from the market. In the event a product, or an ingredient in a product, is classified as a drug or pharmaceutical product in any market, we would generally not be able to distribute that product in that market through our distribution channel because of strict restrictions applicable to drug and pharmaceutical products.

Most of our existing major markets also regulate product claims and advertising regarding the types of claims and representations that can be made regarding the efficacy of products, particularly dietary supplements. Accordingly, these regulations can limit our ability and that of our distributors to inform consumers of the full benefits of our products. For example, in the United States, we are unable to make any claim that any of our nutritional supplements will diagnose, cure, mitigate, treat or prevent disease. The Dietary Supplement Health and Education Act permits only substantiated, truthful and non-misleading statements of nutritional support to be made in labeling, such as statements describing general well-being resulting from consumption of a dietary ingredient or the role of a nutrient or dietary ingredient in affecting or maintaining a structure or a function of the body. In addition, all product claims must be substantiated.

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**Other Regulatory Issues**

As a company incorporated in the United States and operating through subsidiaries in foreign jurisdictions, we are subject to foreign exchange control, various forms of withholding taxes and transfer pricing laws that regulate the flow of funds between our subsidiaries and us for product purchases, management services and contractual obligations such as the payment of distributor commissions.

**Product Warranties and Returns**

The Lexxus refund policies and procedures closely follow industry and country-specific standards, which vary greatly by country. For example, in the United States, the Direct Selling Association recommends that direct sellers permit returns during the twelve-month period following the sale, while in Hong Kong the standard return policy is 14 days following the sale. Our return policies have conformed to local laws or the recommendation of the local direct selling association. In most cases, distributors who timely return unopened product that is in resalable condition may receive a refund. The amount of the refund may be dependent on the country in which the sale occurred, the timeliness of the return, and any applicable re-stocking fee. Lexxus must be notified of the return in writing and such written requests would be considered a termination notice of the distributorship.

From time to time, we alter our return policy in response to special circumstances. For example, in April 2004, an investigative television program was aired in the People's Republic of China with respect to the operations of the Company's Hong Kong subsidiary and the Lexxus representative office located in Beijing. The television program made allegations that Lexxus's Hong Kong operations engaged in fraudulent activities and sold products without proper permits. In order to address the concerns of many independent distributors, Lexxus extended its existing 14-day return policy in Hong Kong to 180 days to allow distributors and customers who purchased products during the two-week period prior to, and the two-week period after, the airing of the television program to return purchased merchandise for a full refund. In October 2004, this special extended product return policy expired.

**Our Industry**

We are engaged in the direct selling industry, selling life-style enhancement products, cosmetics, personal care and nutritional supplements. Direct selling is also referred to as network marketing or multi-level marketing. This type of organizational structure and approach to marketing and sales has proven to be extremely successful for several other direct selling companies, particularly companies selling life-style-enhancement products, cosmetics and nutritional supplements, or selling other types of consumer products, such as Tupperware Corporation and Amway Corp. Generally, direct selling is based upon an organizational structure in which independent distributors of a company's products are compensated for sales made directly to consumers.

Lexxus distributors are compensated for sales generated by distributors they recruited and all subsequent distributors recruited by their down-line network of distributors. The experience of the direct selling industry has been that once a sizeable network of distributors is established, new and alternative products and services can be offered to those distributors for sale to consumers and additional distributors. The successful introduction of new products can dramatically increase sales and profits for both distributors and the direct selling marketing organization.

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Approximately 55 million individuals are now involved in direct selling worldwide and those involved in direct selling generate approximately \$96 billion in annual sales around the world.

	Retail Sales (In Millions)	Number of Distributors (In Thousands)	Sales per Distributor
United States	\$ 29,900	13,600	\$ 2,199
Japan	23,000	2,000	11,500
South Korea	8,030	4,650	1,727
Brazil	3,921	1,539	2,548
Mexico	3,346	1,850	1,809
United Kingdom	3,032	520	5,831
Italy	2,979	272	10,952
Germany	2,875	206	13,956
Taiwan	2,000	3,877	516
France	1,718	170	10,106
Russia	1,268	2,305	550
Malaysia	1,400	3,000	467
Australia	1,083	700	1,547
Canada	1,000	898	1,114
Thailand	880	4,100	215
Argentina	662	683	969
Poland	644	585	1,101
Indonesia	625	5,427	115
Spain	623	136	4,581
Colombia	583	650	897
Other	6,308	7,798	809
Total	\$ 95,877	54,966	1,744

Source: World Federation of Direct Selling Associations ([www.wfdsa.org](http://www.wfdsa.org)) as of March 8, 2006

**Competition**

We compete with a significant number of other retailers that are engaged in similar lines of business, including sellers of health-related products and other direct sellers such as Nu Skin Enterprises, Inc., USANA Health Sciences, Inc., Mannatech, Inc., Reliv International, Inc, and Herbalife, Ltd.. Many of the competitors have greater name recognition and financial resources than us as well as many more distributors. The direct selling channel tends to sell products at a higher price compared to traditional retailers, which poses a degree of competitive risk. There is no assurance that we would continue to compete effectively against retail stores, internet based retailers or other direct sellers.

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**Item 1A. RISK FACTORS**

**Risks Related to Our Business**

**As A Network Marketing Company, We Rely On An Independent Sales Force and We Do Not Have Direct Control Over The Marketing Of Our Products.**

We rely on non-employee, independent distributors to market and sell our products. We have a large number of distributors and a relatively small corporate staff to implement our marketing programs and to provide motivational support and training to our distributors. Directors may voluntarily terminate their agreements with us at any time, and there is typically significant turnover in our distributors from year to year. We anticipate using employees rather than independent distributors to market and sell our products in China.

**Since We Cannot Exert The Same Level Of Influence Or Control Over Our Independent Distributors As We Could Were They Our Own Employees, Our Distributors Could Fail To Comply With Our Distributor Policies and Procedures, Which Could Result in Claims Against Us That Could Harm Our Financial Condition and Operating Results.**

Our distributors are independent contractors and, accordingly, we are not in a position to directly provide the same direction, motivation and oversight as we would if distributors were our own employees. As a result, there can be no assurance that our distributors will participate in our marketing strategies or plans, accept our introduction of new products, or comply with our distributor policies and procedures. Extensive federal, state and local laws regulate our business, our products and our network marketing program. Because we have expanded into foreign countries, our policies and procedures for our independent distributors differ due to the different legal requirements of each country in which we do business. While we have implemented distributor policies and procedures designed to govern distributor conduct and to protect the goodwill associated with the Company's trademarks and tradenames, it can be difficult to enforce these policies and procedures because of the large number of distributors and their independent status given the size and diversity of our distributor force, we experience problems with distributors from time to time, especially with respect to our distributors in foreign markets. Distributors often desire to enter a market, before we have received approval to do business, to gain an advantage in the marketplace. Improper distributor activity in new geographic markets could result in adverse publicity and can be particularly harmful to our ability to ultimately enter these markets. Violations by our distributors of applicable law or of our policies and procedures in dealing with customers could reflect negatively on our products and operations, and harm our business reputation. In addition, it is possible that a court could hold us civilly or criminally accountable based on vicarious liability because of the actions of our independent distributors. If any of these events occur, the value of an investment in our common shares could be impaired.

**Loss Of Key Personnel Could Adversely Affect Our Business.**

Our future success depends to a significant degree on the skills, experience and efforts of our top management. In November 2005, the Company terminated the top two employees, Mark D. Woodburn, formerly the President, and Terry A. LaCore, formerly the Chief Executive Officer of Lexxus U.S., due to misconduct (see Item 1. Recent Developments). The loss of the services of these two individuals could have a material adverse effect on our business, results of operations and financial condition. We also depend on the ability of our executive officers and other members of senior management to work effectively as a team. We currently have an interim Chief Executive Officer, and the failure to identify and hire a permanent replacement, or the loss of one or more of our other executive officers or members of our senior management could have a material adverse effect on our business, results of operations and financial condition.

**We May Be Unable To Protect Our Proprietary Technology Rights.**

Our success depends to a significant degree upon the protection of our MarketVision software and other proprietary technology rights. We rely on trade secret, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. Moreover, the laws of some countries in which we market our products may afford little or no effective protection of our proprietary technology. The reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it. This could have a material adverse effect on our business, operating results and financial condition. If we resort to legal proceedings to enforce our intellectual property rights,

the proceedings could be burdensome and expensive and could involve a high degree of risk.

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**Claims May Arise Against the Company From Unknown Oral Agreements and Misconduct of Former Officers and Directors.**

We continue to investigate oral agreements and misconduct by Mr. Mark Woodburn, a former director and the former President of the Company, and Mr. Terry LaCore, a former director of the Company and the former Chief Executive Officer of the Company's subsidiary, Lexxus U.S. See Item 1. Recent Developments and Item 3. Legal Proceedings. There can be no assurance that all such oral agreements and misconduct have been discovered. Additional discoveries could lead to claims and proceedings against the Company, its subsidiaries and their officers and directors. We are not aware that the Company is the target of any governmental investigation or proceeding. However, if it is determined that any conduct by Messrs. Woodburn and LaCore violated any law, there can be no assurance that the Company or one or more of its subsidiaries would not be subjected to prosecution or adverse proceedings. Any such claims, prosecutions or other proceedings and the cost of their defense could have a material adverse impact on the reputation, business and financial condition of the Company.

**Adverse Publicity Associated With Our Products, Ingredients or Network Marketing Program, or Those of Similar Companies, Could Harm Our Financial Condition and Operating Results.**

Adverse publicity concerning any actual or claimed failure of our Company or our distributors to comply with applicable laws and regulations regarding product claims and advertising, good manufacturing practices, the regulation of our network marketing program, the licensing of our products for sale in our target markets or other aspects of our business, whether or not resulting in enforcement actions or the imposition of penalties, could have an adverse effect on the goodwill of our Company and could negatively affect our ability to attract, motivate and retain distributors, which would negatively impact our ability to generate revenue. We cannot ensure that all distributors will comply with applicable legal requirements relating to the advertising, labeling, licensing or distribution of our products.

In addition, our distributors' and consumers' perception of the safety and quality of our products and ingredients as well as similar products and ingredients distributed by other companies can be significantly influenced by national media attention, publicized scientific research or findings, widespread product liability claims and other publicity concerning our products or ingredients or similar products and ingredients distributed by other companies. Adverse publicity, whether or not accurate or resulting from consumers' use or misuse of our products, that associates consumption of our products or ingredients or any similar products or ingredients with illness or other adverse effects, questions the benefits of our or similar products or claims that any such products are ineffective, inappropriately labeled or have inaccurate instructions as to their use, could negatively impact our reputation or the market demand for our products.

Network marketing systems such as ours are frequently subject to laws and regulations directed at ensuring that product sales are made to consumers of the products and that compensation, recognition, and advancement within the marketing organization are based on the sale of products rather than investment in the sponsoring company. We are subject to the risk that, in one or more of our present or future markets, our marketing system could be found not to comply with these laws and regulations or may be prohibited. Failure to comply with these laws and regulations or such a prohibition could have a material adverse effect on our business, financial condition, and results of operations. Further we may simply be prohibited from distributing products through a network-marketing channel in some foreign countries, or be forced to alter our compensation plan.

**Our Failure To Maintain and Expand Our Distributor Relationships Could Adversely Affect Our Business.**

We distribute our products through independent distributors, and we depend upon them directly for all of our sales. Accordingly, our success depends in significant part upon our ability to attract, retain and motivate a large base of distributors. Our direct selling organization is headed by a relatively small number of key distributors. The loss of a significant number of distributors, including any key distributors, could materially and adversely affect sales of our products and could impair our ability to attract new distributors. Moreover, the replacement of distributors could be difficult because, in our efforts to attract and retain distributors, we compete with other direct selling organizations, including but not limited to those in the personal care, cosmetic product and nutritional supplement industries. Our distributors may terminate their services with us at any time and, in fact, like most direct selling organizations, we have a high rate of attrition.

**If The Number Or Productivity Of Independent Distributors Does Not Increase, Our Revenue Could Not Increase.**

To increase revenue, we must increase the number and/or the productivity of our distributors. We can provide no assurances that distributor numbers could increase or remain constant or that their productivity could increase. We experienced a 33% increase in active Lexxus distributors during 2005, following a 97% increase in active distributors in 2004 compared to the prior years (excluding

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KGC). The number of active distributors may not increase and could decline in the future. Distributors may terminate their services at any time, and, like most direct selling companies, we experience a high turnover among distributors from year to year. We cannot accurately predict any fluctuation in the number and productivity of distributors because we primarily rely upon existing distributors to sponsor and train new distributors and to motivate new and existing distributors. Operating results could be adversely affected if our existing and new business opportunities and products do not generate sufficient economic incentive or interest to retain existing distributors and to attract new distributors.

**Because Our Hong Kong Operations Account For A Majority Of Our Business, Any Adverse Changes In Our Business Operations In Hong Kong Would Materially Harm Our Business.**

In 2003, 2004 and 2005, approximately 49%, 56% and 62% of our revenue, respectively, was generated in Hong Kong. It is anticipated that a higher percentage of our revenue will be generated from Hong Kong in 2006 due to the sales of our interest in KGC in December 2005. Various factors could harm our business in Hong Kong, such as worsening economic conditions or other events that are out of our control. For example, on April 12, 2004, an investigative television program was aired in the People's Republic of China with respect to the operations of the Company's Hong Kong subsidiary and the Lexxus representative office located in Beijing. The television program alleged that Lexxus's Hong Kong operations engaged in fraudulent activities and sold products without proper permits. Due to the adverse publicity caused by the airing of the television program, revenues from Hong Kong declined significantly. Our financial results could be harmed if our products, business opportunity or planned growth initiatives fail to retain and generate continued interest and enthusiasm among our distributors and consumers in this market.

**Our Proposed Operations in China Could Have An Adverse Effect on Our Hong Kong Revenue.**

Most of the Company's Hong Kong revenues are derived from the sale of products that are delivered to members in China. Once we have implemented our proposed operations in China it is possible that sales in Hong Kong could migrate to China. If that were to happen, we could experience a material reduction in sales from Hong Kong.

**Our Business In Hong Kong, Which Represented 62% Of Our Revenue in 2005, May Be Harmed By The Results Of Increased Government Scrutiny of Our Current and Proposed Operations in China.**

Since 1998, direct selling has been restricted in China to ten companies that have an approval that the Company does not currently have. In November 2005, the Chinese government adopted an anti-multilevel marketing legislation ahead of its December 2005 adoption of legislation to legalize direct selling. The government has rigorously monitored multi-level marketing activities and enforced these laws. In the past, the government has taken significant actions against companies that the government found in violation of applicable laws. Governmental actions included shutting down their businesses and arresting alleged perpetrators. Consequently, a few of our direct selling peer companies have modified their business models and started selling to Chinese consumers through owned, leased or franchised retail outlets. We have not implemented our direct sales model in China. We intend to follow the path of some of our competitors and implement a business model that utilizes retail stores and an employee sales force that we believe will comply with applicable regulations. However, currently the Company is generating revenue from its members in China in a manner that, while the Company does not believe violates the anti-multilevel marketing legislation in China, could be deemed by the Chinese government to violate such legislation.

**We Could Be Required To Modify Our Compensation Plan In China In A Way That Could Make It Less Attractive To Members, And This Could Have A Significant Adverse Affect On Our Revenue.**

We could be required to modify our compensation plan in China in a way that could make it less attractive to members. Any such modification to our compensation plan could, therefore, have a material adverse effect on revenue. Moreover, the business model that we anticipate implementing in China will likely involve costs and expenses that we do not generally incur in the e-commerce business that we have historically operated in other markets, including Hong Kong. As a result, the business that we ultimately are able to conduct in China could be materially less profitable than the e-commerce business that we have historically operated in Hong Kong.

**The Company's E-Commerce Business In Hong Kong, Which Represents A Significant Portion Of The Company's Total Revenue, Could Be Adversely Affected By The Activities Of The Members In China, If Members In China Engage In Activities That Are Deemed To Violate China's Anti-Multilevel Marketing Laws.**

While the Company has strictly forbidden any of its members in China to engage in activities that violate China's anti-multilevel marketing laws, some of our members in China have engaged in such activities. In Dongguan, four of



our members were detained for questioning in October 2005 with regard to possible violation of Chinese law regarding the maximum number of people who can attend a meeting as well as possible improper network marketing business activity. Charges were never filed and all individuals were released. In April, 2006, a media report indicated that someone was detained by Public Security in Changsha for investigation of similar allegations. The Company has not been able to determine if the individual in question is, in fact, a member and whether or not any laws were actually broken. Initial inquiries made by retained Chinese counsel indicate that no one is still being detained or has been charged. Reviews and investigations of such activities by government regulators, if any are commenced, could restrict our ability to conduct business.

Most of the Company's Hong Kong revenues are derived from the sale of products that are delivered to members in China. The Company operates an e-commerce direct selling model in Hong Kong and does not recognize this revenue as being

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generated in China. Orders are taken in Hong Kong. Commissions are earned by members in China based on the same binary model used by the Company throughout the world and are recorded and paid in Hong Kong and denominated in Hong Kong Dollars. Commission incomes are declared to the tax authorities in Hong Kong. Members who order the products register themselves with a Hong Kong address and tax ID number. None of the servers on which the Company's Hong Kong e-commerce activities are conducted are located in China. Products purchased by members in China are delivered by the Company to a third party that acts as the importer of record under an agreement to pay applicable duties. From April 2005 through December 2005, the importer of record was a related party (see Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations).

The Company believes that the laws and regulations in China regarding direct selling and multi-level marketing are not specifically applicable to the Company's Hong Kong based e-commerce activity. Nor is the Company aware of any specific laws or regulations in China, or any official interpretation thereof, that govern this Hong Kong centered e-commerce activity. However, there can be no assurance that such laws, regulations or interpretations will not be adopted in the future. Should such laws, rules or interpretations be adopted or should the government determine that the Company's e-commerce activity violates China's anti-multilevel marketing legislation, there could be a material adverse effect on the Company's business, cash flow and financial statements. There is no way the Company can estimate the effect of such an adverse effect.

Although we would attempt to work closely with both national and local governmental agencies in implementing our plans, our efforts to comply with national and local laws may be harmed by a rapidly evolving regulatory climate, concerns about activities resembling violations of anti-multi-level marketing legislation and any subjective interpretation of laws. Any determination that our operations or activities, or the activities of our employee sales representatives, distributors living outside of China or importers of record are not in compliance with applicable regulations could result in the imposition of substantial fines, extended interruptions of business, restrictions on our future ability to obtain business license or expand into new locations, substantially diminishing our ability to retain existing sales representatives and attract new sales representatives, changes to our business model, the termination of required licenses to conduct business, or other actions, all of which would harm our business.

### **If We Fail To Obtain a Direct Selling License in China, Our Future Business Could Be Harmed.**

The Chinese government has adopted new direct selling legislation as of December 1, 2005. The Company has submitted an application for a direct selling license in December 2005. The Company thinks it met all of the legal requirements, including capitalizing our Chinese entity with a \$12.0 million cash infusion, but there can be no assurance that a license will be granted. Although we currently do not operate a direct selling business in China, our future business could be harmed if the Chinese government turns down our application or significantly defers granting a direct selling license.

### **Intellectual Property Rights Are Difficult To Enforce In China.**

Chinese commercial law is relatively undeveloped compared to most other major markets, and, as a result, we may have limited legal recourse in the event we encounter significant difficulties with patent or trademark infringers. Limited protection of intellectual property is available under Chinese law, and the local manufacturing of our products may subject us to an increased risk that unauthorized parties may attempt to copy or otherwise obtain or use our product formulations. As a result, we cannot assure you that we would be able to adequately protect our product formulations.

### **Failure to Properly Pay Business Taxes, Including Those in China, Could Have a Material Adverse Effect.**

Between April and December 2005, the Company's Hong Kong subsidiary engaged a service provider to facilitate product importation into China and act, or engage another party to act, as the importer of record. The individual that owns that service provider is one of the directors of the Company's wholly-owned Chinese subsidiary. The Company believes that the amount of duty paid to Chinese Customs on the imported goods by the importer of record was paid at the negotiated rate. However, there can be no assurance that Chinese Customs will not elect, in the future, to examine the duty paid, and if they conduct such examination, they may conclude that the valuation established was insufficient, resulting in an underpayment of duties. As a consequence, the importer of record could be required to pay additional duties and possible penalties to Chinese Customs. Additional duties could range between zero and \$46.0 million, plus penalties. The extreme worst case was calculated using the highest possible assessment to the highest possible

declared value and assuming that negotiated valuation practices do not apply. The Company believes that any such future assessment of additional duties or penalties would be made against and become the responsibility of the importer of record. There can be no assurance that the Company or its subsidiaries would not also be assessed with such liability in the event that the importer of record is unable to pay all or part of such amount.

**As We Continue To Expand Into Foreign Markets Our Business Becomes Increasingly Subject To Political and Economic Risks. Changes In These Markets Could Adversely Affect Our Business.**

We believe that our ability to achieve future growth is dependent in part on our ability to continue our international expansion efforts. However, there can be no assurance that we would be able to grow in our existing international markets, enter new international markets on a timely basis, or that new markets would be profitable. We must overcome significant regulatory and legal barriers before we can begin marketing in any foreign market.

Also, it is difficult to assess the extent to which our products and sales techniques would be accepted or successful in any given country. In addition to significant regulatory barriers, we may also encounter problems conducting operations in new markets with different cultures and legal systems from those encountered elsewhere. We may be required to reformulate certain of our products before commencing sales in a given country. Once we have entered a market, we must adhere to the regulatory and legal requirements of that market. No assurance can be given that we would be able to successfully reformulate our products in any of our current or potential international markets to meet local regulatory requirements or attract local customers. The failure to do so could have a

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material adverse effect on our business, financial condition, and results of operations. There can be no assurance that we would be able to obtain and retain necessary permits and approvals.

In many markets, other direct selling companies already have significant market penetration, the effect of which could be to desensitize the local distributor population to a new opportunity, or to make it more difficult for us to recruit qualified distributors. There can be no assurance that, even if we are able to commence operations in foreign countries, there would be a sufficiently large population of potential distributors inclined to participate in a direct selling system offered by us. We believe our future success could depend in part on our ability to seamlessly integrate our business methods, including distributor compensation plan, across all markets in which our products are sold.

There can be no assurance that we would be able to further develop and maintain a seamless compensation program.

### **An Increase In The Amount Of Compensation Paid To Distributors Would Reduce Profitability.**

A significant expense is the payment of compensation to our distributors. We paid approximately 44%, 51% and 52% in 2003, 2004 and 2005, respectively, of our net revenues as compensation to our distributors. The increase is due to the growth of the distributor network and number of down-line levels, an elevated level of promotions, local promotional programs and various business development agreements. We compensate our distributors by paying commissions, bonuses, and certain awards and prizes. We closely monitor the amount of compensation to distributors paid as a percentage of net sales and may need to adjust our compensation plan to prevent distributor compensation from having a significant adverse effect on earnings. There can be no assurance that these changes or future changes to our compensation plan or product pricing would be successful in maintaining the level of distributor compensation expense as a percentage of net sales. Furthermore, these changes may make it difficult to recruit and retain qualified and motivated distributors. An increase in compensation payments to distributors as a percentage of net sales will reduce our profitability. Under our current compensation plan, commissions may be limited to 60% of sales. See

Item 1. Working with Distributors Compensation Plans.

### **There May be Unfavorable Reactions to or Challenges to Our Use the New Name We Have Selected for our Lexxus Subsidiaries, Internet Sites and Certain Products.**

In connection with the settlement of a lawsuit, the Company is obligated to change the name of its Lexxus subsidiaries, websites and certain products (see Item 3. Legal Proceedings ). It is anticipated that, by June 1, 2006, the Company will change the name of Lexxus International to NHT Global, Inc. and the terms Lexxus and Lexxus International will be replaced in all other uses by the Company and its subsidiaries by the terms NHT Global or a variation that includes NHT or Natural Health Trends . The financial condition of the Company could be materially affected by unfavorable reaction of distributors and customers to these new names or by claims of prior rights to these names in one or more countries.

### **We Do Not Have Product Liability Insurance And Product Liability Claims Could Hurt Our Business.**

Currently, we do not have product liability insurance, although the insurance carried by our suppliers may cover certain product liability claims against us. Nevertheless, we do not conduct or sponsor clinical studies of our products. As a marketer of nutraceuticals, cosmetics and other products that are ingested by consumers or applied to their bodies, we may become subjected to various product liability claims, including that:

our products contain contaminants;

our products include inadequate instructions as to their uses; or

our products include inadequate warnings concerning side effects and interactions with other substances.

Especially since we do not have direct product liability insurance, it is possible that product liability claims and the resulting adverse publicity could negatively affect our business. In November 2004, Dorothy Porter filed a complaint against the Company for strict liability, breach of warranty and negligence in the U.S. District Court for the Southern District of Illinois, alleging that she sustained a brain hemorrhage after taking Formula One, an ephedra-containing product marketed by Kaire Nutraceuticals, Inc., a former subsidiary of the Company. See Item 3. Legal Proceedings .

If our suppliers product liability insurance fails to cover product liability claims or other product liability claims, or any product liability claims exceeds the amount of coverage provided by such policies or if we are unsuccessful in any third party claim against the manufacturer or if we are unsuccessful in collecting any judgment that may be recovered

by the Company against the manufacturer,

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we could be required to pay substantial monetary damages which could materially harm our business, financial condition and results of operations. As a result, we may become required to pay higher premiums and accept higher deductibles in order to secure adequate insurance coverage in the future.

**Our Internal Controls and Accounting Methods Require Further Modification.**

The Company modified certain of its accounting policies and made other adjustments to our accounting for past transactions, which resulted in the restatement of the Company's financial statements for each quarter in 2001, 2002, and 2003, for the years ended December 31, 2001, 2002, and 2003, as well as the first quarter in 2004. In connection with the restatement of our financial statements, many of the restatement items are the result of material weaknesses in the Company's internal controls and procedures. Also, in October 2005, the Company's top two officers at the time, Mark Woodburn and Terry LaCore, the President of the Company and the Chief Executive Officer of Lexxus U.S., respectively, were terminated due to management misconduct.

The Company continues to develop controls and procedures and plans to implement additional controls and procedures sufficient to accurately report our financial performance on a timely basis in the foreseeable future. Nevertheless, we continue to have material weaknesses (see Item 9A Controls and Procedures). If we are unable to develop and implement effective controls and procedures, we may not be able to report our financial performance on a timely basis and our business and stock price would be adversely affected. See Item 9A. Controls and Procedures.

**Non-Compliance with Section 404 of the Sarbanes-Oxley Act of 2002 Could Materially Adversely Affect Us.**

The Securities Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules which could require us to include in our annual reports on Form 10-K, beginning in fiscal 2007, an assessment by management of the effectiveness of our internal controls over financial reporting. In addition, our independent auditors must attest to and report on management's assessment of the effectiveness of such internal controls over financial reporting. While we intend to diligently and thoroughly document, review, test and improve our internal controls over financial reporting to comply with Section 404 of the Sarbanes-Oxley Act, if our independent auditors are not satisfied with the adequacy of our internal controls over financial reporting, or if the independent auditors interpret the requirements, rules and/or regulations differently than we do, then they may decline to attest to management's assessment or may issue a report that is qualified. This could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which could negatively impact the price of our common stock.

**We Rely On And Are Subject To Risks Associated With Our Reliance Upon Information Technology Systems.**

Our success is dependent on the accuracy, reliability, and proper use of information processing systems and management information technology. Our information technology systems are designed and selected to facilitate order entry and customer billing, maintain distributor records, accurately track purchases and distributor compensation payments, manage accounting operations, generate reports, and provide customer service and technical support. Although we acquired MarketVision our distributor software service provider during the first half of 2004, in part, to gain greater control over its operations, any interruption in these systems could have a material adverse effect on our business, financial condition, and results of operations.

**Our Lexxus Subsidiaries Have a Limited Operating History Which May Not be Indicative of Future Performance.**

Although our Lexxus subsidiaries accounted for approximately 99% of our consolidated net revenues during fiscal 2005, it has been operating only since January 2001.

Our business prospects must be considered in light of the risk, expense and difficulties frequently encountered by companies in an early stage of development, particularly companies in new and rapidly evolving international markets. If we are unable to effectively allocate our resources and help grow our Lexxus subsidiaries, our stock price may be adversely affected and we may be unable to execute our strategy of expanding our network of independent distributors. Our business depends upon the performance of our Lexxus subsidiaries and, due to its relatively short operating history, past performance may not be indicative of future results.

Our success has been, and could continue to be, significantly dependent on our ability to manage rapid growth through expansions and enhancements of our worldwide personnel and management, order processing and fulfillment,

inventory and shipping systems, financial reporting and other aspects of operations. As we continue to expand our operations, the ability to manage this growth could

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represent an increasing challenge and our failure to properly manage this growth may materially and adversely affect our results of operation.

**Regulatory Matters Governing Our Industry Could Have A Significant Negative Effect On Our Business.**

In both our United States and foreign markets, we are affected by extensive laws, governmental regulations, administrative determinations, court decisions and similar constraints. Such laws, regulations and other constraints may exist at the federal, state or local levels in the United States and at all levels of government in foreign jurisdictions.

**Product Regulations**

The formulation, manufacturing, packaging, labeling, distribution, importation, sale and storage of certain of our products are subject to extensive regulation by various federal agencies, including the Food and Drug Administration ( FDA ), the Federal Trade Commission (the FTC ), the Consumer Product Safety Commission and the United States Department of Agriculture and by various agencies of the states, localities and foreign countries in which our products are manufactured, distributed and sold. Failure by our distributors or us to comply with those regulations could lead to the imposition of significant penalties or claims and could materially and adversely affect our business. In addition, the adoption of new regulations or changes in the interpretation of existing regulations may result in significant compliance costs or discontinuation of product sales and may adversely affect the marketing of our products, resulting in significant loss of sales revenues.

**Product Claims, Advertising and Distributor Activities**

Our failure to comply with FTC or state regulations, or with regulations in foreign markets that cover our product claims and advertising, including direct claims and advertising by us, as well as claims and advertising by distributors for which we may be held responsible, may result in enforcement actions and imposition of penalties or otherwise materially and adversely affect the distribution and sale of our products. Distributor activities in our existing markets that violate applicable governmental laws or regulations could result in governmental or private actions against us in markets where we operate. Given the size of our distributor force, we cannot assure that our distributors would comply with applicable legal requirements.

**Direct Selling System**

Our direct selling system is subject to a number of federal and state regulations administered by the FTC and various state agencies as well as regulations in foreign markets administered by foreign agencies. Regulations applicable to direct selling organizations generally are directed at ensuring that product sales ultimately are made to consumers and that advancement within the organizations is based on sales of the organizations products rather than investments in the organizations or other non-retail sales related criteria. We are subject to the risk that, in one or more markets, our marketing system could be found not to be in compliance with applicable regulations. The failure of our direct selling system to comply with such regulations could have a material adverse effect on our business in a particular market or in general.

We are also subject to the risk of private party challenges to the legality of our direct selling system. The regulatory requirements concerning direct selling systems do not include bright line rules and are inherently fact-based. An adverse judicial determination with respect to our direct selling system, or in proceedings not involving us directly but which challenge the legality of other direct selling marketing systems, could have a material adverse effect on our business.

**Transfer Pricing and Similar Regulations**

In many countries, including the United States, we are subject to transfer pricing and other tax regulations designed to ensure that appropriate levels of income are reported as earned by our United States or local entities and are taxed accordingly. In addition, our operations are subject to regulations designed to ensure that appropriate levels of customs duties are assessed on the importation of our products.

Our principal domicile is the United States. Under tax treaties, we are eligible to receive foreign tax credits in the United States for taxes paid abroad. As our operations expand outside the United States, taxes paid to foreign taxing authorities may exceed the credits available to us, resulting in the payment of a higher overall effective tax rate on our worldwide operations.





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We have adopted transfer pricing agreements with our subsidiaries to regulate inter-company transfers, which agreements are subject to transfer pricing laws that regulate the flow of funds between the subsidiaries and the parent corporation for product purchases, management services, and contractual obligations, such as the payment of distributor compensation. In 2005, we implemented a foreign holding and operating company structure for our non-United States businesses. This new structure re-organized our non-United States subsidiaries in the Cayman Islands. Though our goal is to improve the overall tax rate, there is no assurance that the new tax structure could be successful. If the United States Internal Revenue Service or the taxing authorities of any other jurisdiction were to successfully challenge these agreements, plans, or arrangements, or require changes in our transfer pricing practices, we could be required to pay higher taxes, interest and penalties, and our earnings would be adversely affected.

We believe that we operate in compliance with all applicable transfer pricing laws and we intend to continue to operate in compliance with such laws. However, there can be no assurance that we will continue to be found to be operating in compliance with transfer pricing laws, or that those laws would not be modified, which, as a result, may require changes in our operating procedures.

**Taxation Relating To Distributors**

Our distributors are subject to taxation, and in some instances legislation or governmental agencies impose an obligation on us to collect the taxes, such as value added taxes, and to maintain appropriate records. In addition, we are subject to the risk in some jurisdictions of being responsible for social security and similar taxes with respect to our distributors.

**Other Regulations**

We are also subject to a variety of other regulations in various foreign markets, including regulations pertaining to employment and severance pay requirements, import/export regulations and antitrust issues. Our failure to comply or assertions that we fail to comply with these regulations could have a material adverse effect on our business in a particular market or in general.

To the extent we decide to commence or expand operations in additional countries, government regulations in those countries may prevent or delay entry into or expansion of operations in those markets. In addition, our ability to sustain satisfactory levels of sales in our markets is dependent in significant part on our ability to introduce additional products into the markets. However, government regulations in both our domestic and international markets can delay or prevent the introduction, or require the reformulation or withdrawal, of some of our products.

**Currency Exchange Rate Fluctuations Could Lower Our Revenue And Net Income.**

In 2005, approximately 92% of our revenue was recorded in markets outside the United States. However, that figure does not accurately reflect our foreign currency exposure mainly because the Hong Kong dollar is pegged to the U.S. dollar. Our European business, KGC, switched to euro for both selling products and paying commissions at the end of 2004 but has been divested and thus no longer consolidated with the Company in 2006. We also purchase all inventories in U.S. dollars. Therefore, our currency exposure, mainly to Korean won, Singapore dollar, New Taiwan dollar and Australia dollar, represented approximately 12% of our revenue in 2005, excluding KGC.

Our exposure to foreign currency fluctuation is expected to increase, as the Company progresses in developing Japanese and Mexican markets.

In preparing our consolidated financial statements, we translate revenue and expenses in foreign countries from their local currencies into U.S. dollars using the average exchange rates for the period. The effect of the translation of the Company's foreign operations is included in accumulated other comprehensive income within stockholders' equity and do not impact the statement of operations.

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Given our inability to predict the degree of exchange rate fluctuations, we cannot estimate the effect these fluctuations may have upon future reported results, product pricing or our overall financial condition. Further, to date we have not attempted to reduce our exposure to short-term exchange rate fluctuations by using foreign currency exchange contracts.

### **Failure Of New Products To Gain Distributor And Market Acceptance Could Harm Our Business.**

An important component of our business is our ability to develop new products that create enthusiasm among our distributor force. If we fail to introduce new products on a timely basis, our distributor productivity could be harmed. In addition, if any new products fail to gain market acceptance, are restricted by regulatory requirements, or have quality problems, this would harm our results of operations. Factors that could affect our ability to continue to introduce new products include, among others, limited capital resources, government regulations, proprietary protections of competitors that may limit our ability to offer comparable products and any failure to anticipate changes in consumer tastes and buying preferences.

### **System Failures Could Harm Our Business.**

Because of our diverse geographic operations and our internationally applicable distributor compensation plans, our business is highly dependent on efficiently functioning information technology systems provided by MarketVision. The MarketVision systems and operations are vulnerable to damage or interruption from fires, earthquakes, telecommunications failures, computer viruses and worms, software defects and other events. They are also subject to break-ins, sabotage, acts of vandalism and similar misconduct. Despite precautions implemented by the staff of MarketVision, problems could result in interruptions in services and materially and adversely affect our business, financial condition and results of operations.

### **Limited Product Line.**

The Company offers a limited number of products under its Lexxus brand (see Item 1. Our Principal Products ). Our *Premium Noni Juice* , *Skindulgence*®, *Alura*® and *La Vie* products each account for a significant portion of our total sales and, together, account for a significant majority of our total sales. If demand for any of these four products decreases significantly, government regulation restricts the sale of these products, we are unable to adequately source or deliver these products, or we cease offering any of these products for any reason without a suitable replacement, our business, financial condition and results of operations could be materially and adversely effected.

### **We Do Not Manufacture Our Own Products So We Must Rely On Independent Third Parties For The Manufacturing And Supply Of Our Products.**

All of our products are manufactured by independent third parties. There is no assurance that our current manufacturers will continue to reliably supply products to us at the level of quality we require. In the event any of our third-party manufacturers become unable or unwilling to continue to provide the products in required volumes and quality levels at acceptable prices, we will be required to identify and obtain acceptable replacement manufacturing sources. There is no assurance that we will be able to obtain alternative manufacturing sources or be able to do so on a timely basis. An extended interruption in the supply of our products will result in a substantial loss of sales. In addition, any actual or perceived degradation of product quality as a result of our reliance on third party manufacturers may have an adverse effect on sales or result in increased product returns and buybacks.

### **The High Level Of Competition In Our Industry Could Adversely Affect Our Business.**

The business of marketing personal care, cosmetic, nutraceutical, and lifestyle enhancement products is highly competitive. This market segment includes numerous manufacturers, distributors, marketers, and retailers that actively compete for the business of consumers both in the United States and abroad. The market is highly sensitive to the introduction of new products, which may rapidly capture a significant share of the market. Sales of similar products by competitors may materially and adversely affect our business, financial condition and results of operations.

We are subject to significant competition for the recruitment of distributors from other direct selling organizations, including those that market similar products. Many of our competitors are substantially larger than we are, offer a wider array of products, have far greater financial resources and many more active distributors than we have. Our ability to remain competitive depends, in significant part, on our success in recruiting and retaining distributors through an attractive compensation plan and other incentives. We believe that our compensation and incentive programs provide our distributors with significant earning potential. However, we cannot be sure that our programs

for recruitment and retention of distributors would be successful.

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**Terrorist Attacks, Acts Of War, Epidemics Or Other Communicable Diseases Or Any Other Natural Disasters May Seriously Harm Our Business.**

Terrorist attacks, or acts of war or natural disasters may cause damage or disruption to our Company, our employees, our facilities and our customers, which could impact our revenues, expenses and financial condition. The potential for future terrorist attacks, the national and international responses to terrorist attacks, and other acts of war or hostility, such as the Chinese objection to the Taiwan independence movement and its resultant tension in the Taiwan Strait, could materially and adversely affect our business, results of operations, and financial condition in ways that we currently cannot predict. Additionally, natural disasters less severe than the Indian Ocean tsunami that occurred in December 2004 may adversely affect our business, financial condition and results of operations.

**Risks Related To Our Common Stock**

**Disappointing Quarterly Revenue Or Operating Results Could Cause The Price Of Our Common Stock To Fall.**

Our quarterly revenue and operating results are difficult to predict and do fluctuate significantly from quarter to quarter. If our quarterly revenue or operating results fall below the expectations of investors or securities analysts, the price of our common stock could fall substantially.

**Our Common Stock Is Particularly Subject To Volatility Because Of The Industry That We Are In.**

The market prices of securities of direct selling companies, have been extremely volatile, and have experienced fluctuations that have often been unrelated or disproportionate to the operating performance of such companies. These broad market fluctuations could adversely affect the market price of our common stock.

**Substantial Dilution May Occur From The Exercise of Outstanding Options or Warrants**

As of December 31, 2005, the Company had outstanding (i) options to purchase an aggregate of 1,922,124 shares of our common stock at exercise prices between \$1.00 and \$18.11, and (ii) warrants outstanding from the October 2004 private placement of units exercisable for 1,080,504 shares of our common stock at an exercise price equal to \$12.47 per share. In the event that these options and warrants are exercised, and the shares issued upon such exercise are sold, the market price of our shares of common stock could decline. In addition, holders of such options and warrants are likely to exercise them when, in all likelihood, the Company could obtain additional capital on terms more favorable to the Company than those provided by the options and warrants. Further, while our options and warrants are outstanding, they may adversely affect the terms on which the Company could obtain additional capital.

Moreover, on February 10, 2006, the Company entered into an Escrow Agreement (the *Agreement*) with Messrs. Woodburn and LaCore, the LaCore and Woodburn Partnership, an affiliate of Woodburn and LaCore, and Krage and Janvey LLP, as escrow agent (the *Agent*). Pursuant to the Agreement, (i) the Company agreed to issue and deposit with the Agent stock certificates in the name of the Agent representing an aggregate of 1,081,066 shares of the Company's common stock (the *Escrowed Shares*) and (ii) Woodburn and LaCore deposited with the Agent \$1,206,000 in immediately available funds (the *Cash Deposit*). The Escrowed Shares are the shares of common stock issuable upon the cashless exercise of certain options issued in 2001 and 2002 to LaCore and the LaCore and Woodburn Partnership exercisable at \$1.00 and \$1.10 per share. The number of Escrow Shares is based upon the closing price of the Company's common stock on February 9, 2006 of \$10.14 and the surrender of 118,934 option shares as payment of the aggregate exercise price of \$1,206,000.

The Escrowed Shares were issued pursuant to Section 4(2) of the Securities Act of 1933, as amended, to the Agent upon receipt from the Agent of an irrevocable proxy (the *Proxy*) to the Company to vote the Escrowed Shares on all matters presented at meetings of stockholders or any written consent executed in lieu thereof. The parties have agreed that the Agent will hold the Escrowed Shares and the Cash Deposit until it receives (i) joint written instructions from the Company, Woodburn and LaCore, or (ii) a final non-appealable order from a court of competent jurisdiction. Each of the Company and Woodburn and LaCore has further agreed that all current and future rights, claims, defenses and causes of actions they have or may have against each other are preserved. If the Escrowed Shares are released to Woodburn and LaCore or sold to a third party, the market price of our shares of common stock could decline.

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**Future Sales By the Company or Existing Security Holders Could Depress The Market Price Of Our Common Stock.**

If the Company or our existing stockholders sell a large number of shares of our common stock, the market price of the common stock could decline significantly. Further, even the perception in the public market that the Company or our existing stockholders might sell shares of common stock could depress the market price of the common stock.

**There is No Assurance That an Active Public Trading Market Would Continue.**

The Company's common stock is not heavily traded. The Company's common stock began trading on The NASDAQ National Market under the ticker symbol BHIP only since February 22, 2005. There can be no assurance that an active public trading market for our common stock will be sustained. If for any reason an active public trading market does not continue, purchasers of the shares of our common stock may have difficulty in selling their securities should they desire to do so and the price of our common stock may decline.

**If Securities Analysts Do Not Publish Research Or Reports About Our Business Or If They Downgrade Our Stock, The Price Of Our Stock Could Decline.**

The trading market for our shares of common stock could rely in part on the research and reporting that industry or financial analysts publish about us or our business. We do not control these analysts. Furthermore, if one or more of the analysts who do cover us downgrades our stock, the price of our stock could decline. If one or more of these analysts ceases coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

**Item 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**Item 2. PROPERTIES**

The Company leases approximately 53,375 square feet in Dallas, Texas for its headquarters and warehouse space. The warehouse primarily stores products that are bound for international markets. The Company's subsidiary, MarketVision, leases office space in Minnesota for its employees.

Outside the United States, we have operations in leased sites in Hong Kong, China, Japan, Taiwan, Singapore, South Korea, the Philippines, Australia, Mexico, the Cayman Islands and Canada. We also lease a manufacturing facility in China for assembly operations. We believe that our existing properties are in good condition and suitable for the conduct of our business.

**Item 3. LEGAL PROCEEDINGS**

During the fall of 2003, the customs agency of the government of South Korea brought a charge against LXX, the Company's wholly-owned subsidiary operating in South Korea, with respect to the importation of the Company's Alura product. The customs agency alleges that Alura is not a cosmetic product, but rather should be categorized and imported as a pharmaceutical product. On February 18, 2005, the Seoul Central District Court ruled against LXX and fined it a total of approximately \$200,000. LXX also incurred related costs of approximately \$40,000 as a result of the judgment. The Company recorded a reserve for the entire \$240,000 at December 31, 2004 and has appealed the ruling. The failure to sell Alura in South Korea is not anticipated to have a material adverse effect on the financial condition, results of operations, cash flow or business prospects of LXX.

On or around March 31, 2004, Lexxus U.S. received a letter from John Loghry, a former Lexxus distributor, alleging that Lexxus U.S. had wrongfully terminated an alleged oral distributorship agreement with Mr. Loghry and that the Company had breached an alleged oral agreement to issue shares of the Company's common stock to Mr. Loghry. On May 13, 2004, Lexxus U.S. and the Company filed an action against Mr. Loghry in the United States District Court for the Northern District of Texas seeking, inter alia, unspecified damages from Mr. Loghry for disparagement and a declaration that Mr. Loghry was not wrongfully terminated and is not entitled to recover anything from Lexxus U.S. or the Company. Mr. Loghry filed counterclaims against the Company and Lexxus U.S. asserting his previously threatened claims. In September 2004, Mr. Loghry filed third party claims against certain officers of the Company and Lexxus U.S., including against Terry LaCore, former Chief Executive Officer of Lexxus U.S. and former director of the Company, and Mark Woodburn, former President and director of the Company, for fraud, Messrs. LaCore, Woodburn, and a certain Lexxus distributor for conspiracy to commit fraud and tortious interference with contract. In February 2005, the court dismissed all of



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Mr. Loghry's claims against the individual defendants, except the claims for fraud and conspiracy to commit fraud. Mr. Loghry then filed amended counterclaims and, on June 2, 2005, the Company and the other counterclaim defendants moved to dismiss the counterclaims on the grounds that the claims were barred by Mr. Loghry's failure to disclose their existence when he filed for personal bankruptcy in September 2002. On June 30, 2005, the U.S. Bankruptcy Court for the District of Nebraska granted Mr. Loghry's request to reopen his bankruptcy case. On September 6, 2005, the United States Trustee filed an action in the U.S. District Court for the District of Nebraska against the Company; Lexxus U.S.; Messrs. LaCore and Woodburn; Curtis Broome, President of Greater China and Southeast Asia; and a certain independent distributor of Lexxus U.S., essentially alleging the same claims asserted by Loghry in the Northern District of Texas. On February 21, 2006, this case was transferred to the United States District Court for the Northern District of Texas. The Company denies the allegations by Loghry and the United States Trustee and intends to vigorously contest their claims. An unfavorable judgment could have a material adverse effect on the financial condition of the Company.

On November 1, 2004, Toyota Jidosha Kabushiki Kaisha (d/b/a Toyota Motor Corporation) and Toyota Motor Sales, U.S.A. (the Toyota Entities) filed a complaint against the Company and Lexxus U.S. in United States District Court for the Central District of California (CV04-9028). The complaint alleged trademark and service mark dilution, unfair competition, trademark and service mark infringement, and trade name infringement, each with respect to Toyota's Lexus trademark. The Company reached a settlement agreement, dated August 31, 2005, under which the Toyota Entities agreed to terminate their claims against the Company, and the Company agreed to discontinue use of the Lexxus name and mark and change the name of its Lexxus operations and domain names by June 1, 2006, and sell or otherwise dispose of all product inventory marked with the name Lexxus by December 1, 2006. This could have a material adverse effect on the financial condition, results of operations, cash flow or business prospects of the Company.

On November 12, 2004, Dorothy Porter filed a complaint against the Company in the United States District Court for the Southern District of Illinois alleging that she sustained a brain hemorrhage after taking Formula One, an ephedra-containing product marketed by Kaire Nutraceutical Inc., a former subsidiary of the Company, and, thereafter, eKaire.com, Inc., a wholly-owned subsidiary of the Company. Ms. Porter has sued the Company for strict liability, breach of warranty and negligence. The Company intends to defend this case vigorously and on December 27, 2004 filed an answer denying the allegations contained in the complaint. On March 7, 2005, a Notice of Tag-Along Action was filed by Ms. Porter with the Judicial Panel on Multidistrict Litigation. The case was subsequently transferred for pre-trial purposes to the consolidated Ephedra Products Liability proceedings in the United States District Court for the Southern District of New York. If the case proceeds to a jury trial, the matter will be transferred back to the Southern District of Illinois and tried in that District. Full discovery between the parties is set to begin in this action Spring 2006. The Company does not believe that the plaintiff can demonstrate that its products caused the alleged injury and intends to vigorously defend this action.

On January 13, 2005, Nature's Sunshine Products, Inc. and Nature's Sunshine Products de Mexico S.A. de C.V. (collectively Nature's Sunshine) filed suit against the Company in the Fourth Judicial District Court, Utah County, State of Utah, seeking injunctive relief and unspecified damages against the Company, Lexxus U.S., the Company's Mexican subsidiary, and the Company's Mexico management team, Oscar de la Mora Romo and Jose Villarreal Patino, alleging among other things that the Company's employment of Messrs. De la Mora and Villarreal violated or could lead to the violation of certain non-compete, non-solicitation, and confidentiality agreements allegedly in effect between Messrs. De la Mora and Villarreal and Nature's Sunshine. After the Company removed the case to federal court, Nature's Sunshine voluntarily dismissed its lawsuit and filed a new lawsuit in the Fourth Judicial District Court in Utah County, Utah. After a hearing on August 22, 2005, the district court preliminarily enjoined Messrs. De la Mora and Villarreal from disclosing any confidential information of Nature's Sunshine or soliciting any employee or distributor of Nature's Sunshine or inducing them to terminate their relationship with Nature's Sunshine. The court refused, however, to enjoin Messrs. De la Mora or Villarreal from competing with Nature's Sunshine. Nature's Sunshine subsequently filed a petition for interlocutory review with the Utah Supreme Court. The Supreme Court delegated the petition to the Utah Court of Appeals, which denied the petition. On April 6, 2006, a mutual agreement was entered into with Messrs. De la Mora and Villarreal terminating their employment between them and affiliates of



the Company. If the Company or Messrs. De la Mora and Villarreal are nevertheless unsuccessful in defending this action, the Company may be required to pay any damages and attorneys' fees that may be assessed against it.

On or about March 1, 2006, the Company hired Peter Dale, a former executive with the Nature's Sunshine subsidiary doing business in Japan, Nature's Sunshine Japan Co., Ltd. ( NSJ ), to serve as an executive vice president with responsibilities in Asia. NSJ alleges that Mr. Dale has signed an agreement containing covenants of non-competition, non-solicitation, and confidentiality, and that it believes Mr. Dale's employment with the Company would violate the non-competition covenant. No lawsuit has been filed at this point. If Nature's Sunshine files suit, the Company and Mr. Dale will vigorously defend against the enforcement of the non-competition covenant. However, if Nature's Sunshine were to prevail in such a lawsuit, Mr. Dale could be enjoined from working for the Company until February 15, 2007 which could have a material adverse effect on the Company's business in Japan.

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Currently, there is no other significant litigation pending against the Company other than as disclosed in the paragraphs above. From time to time, the Company may become a party to litigation and subject to claims incident to the ordinary course of the Company's business. Although the results of such litigation and claims in the ordinary course of business cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material adverse effect on the Company's business, results of operations or financial condition. Regardless of outcome, litigation can have an adverse impact on the Company because of defense costs, diversion of management resources and other factors.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

On June 1, 2005, the Company held its annual meeting of shareholders. At the meeting, the shareholders (i) approved the re-election of the Company's five directors to the Board of Directors of the Company, (ii) ratified the appointment of BDO Seidman, LLP as the Company's independent auditors for the fiscal year ending December 31, 2005, and (iii) approved certain amendments to the Company's 2002 Stock Option Plan. The fourth proposal presented at the annual meeting which addressed the reincorporation of the Company in the State of Delaware was adjourned until June 24, 2005. At that time, the Company's reincorporation in the State of Delaware was approved by holders of a majority of the Company's shares of common stock outstanding. On June 29, 2005, the Company re-incorporated in the State of Delaware.

**Table of Contents****Part II****Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Market Information**

Our common stock has been quoted on The NASDAQ National Market under the symbol **BHIP** since February 22, 2005. Prior to that time, our common stock was quoted on the NASD over-the-counter bulletin board under the symbol **NHTC** and subsequently **NHLC.OB**.

The following table sets forth the range of high and low bid quotations for our common stock for each of the quarterly periods indicated as reported on the NASD over-the-counter bulletin board and The NASDAQ National Market. Bid quotations as reported on the NASD over-the-counter bulletin board reflect inter-dealer prices without retail markup, markdown, or commission and may not represent actual transactions.

Quarter Ended:	High	Low
March 31, 2004	\$ 21.10	\$ 10.80
June 30, 2004	25.75	11.40
September 30, 2004	18.60	11.99
December 31, 2004	12.70	9.15
March 31, 2005	\$ 18.89	\$ 11.00
June 30, 2005	15.00	11.12
September 30, 2005	17.07	12.66
December 31, 2005	16.00	8.27

At April 28, 2006, there were approximately 420 stockholders of record, and the closing price of our common stock was \$5.99 per share. We estimate that as of such date there were approximately 3,250 beneficial holders of our common stock.

On April 18, 2006, the Company received a letter from The NASDAQ Stock Market stating that the Company is not in compliance with Marketplace Rule 4310(c)(14), which obligates listed issuers to timely file those reports and other documents required to be filed with the Securities and Exchange Commission. On April 25, 2006, the Company requested a hearing with the NASDAQ Hearings Panel concerning the Company's failure to file its Form 10-K in a timely fashion. The Company received a hearing date of June 1, 2006 from NASDAQ. The Company has been advised that its shares of common stock will not be delisted prior to the date of the hearing.

**Dividend Policy**

We have never declared or paid any cash dividend on our common stock. We currently intend to retain earnings, if any, to finance the growth and development of our business. We do not expect to pay any dividends in the foreseeable future. Payment of any future dividends will be at the direction of our Board of Directors.

**Table of Contents****Equity Compensation Plan Information**

The following table provides information as of December 31, 2005 with respect to the Company's common stock that may be issued upon the exercise of options, warrants and rights under all of our existing equity compensation plans (including individual arrangements).

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	592,124	\$ 14.41	957,876 <sup>1</sup>
Equity compensation plans or arrangements not approved by security holders	1,330,000 <sup>2</sup>	\$ 1.06	
Total	1,922,124	\$ 5.17	957,876

<sup>1</sup> On June 1, 2005, an amendment was approved which increased the number of shares of common stock reserved under the 2002 Stock Option Plan to 1,550,000 shares.

<sup>2</sup> Includes (i) options exercisable for 570,000 shares of common stock issued to the LaCore and Woodburn Partnership, (ii) options exercisable for

570,000 shares of common stock issued to Mr. LaCore, (iii) options exercisable for 30,000 shares of common stock issued to Benchmark Consulting Group (which was subsequently assigned to the LaCore and Woodburn Partnership), (iv) options exercisable for 30,000 shares of common stock issued to Mr. LaCore, (v) options exercisable for 125,000 shares of common stock issued to certain employees and members of the Company's board of directors, and (vi) options exercisable for 5,000 shares of common stock issued to an unrelated party. See Item 1. Recent Developments regarding the exercise of stock options issued to the LaCore and Woodburn Partnership and

to Mr. LaCore.

**Table of Contents****Item 6. SELECTED FINANCIAL DATA**

The following data has been derived from the audited consolidated financial statements of the Company and should be read in conjunction with those statements. Historical results are not necessarily indicative of future results.

	Year Ended December 31,				
	2001	2002	2003	2004	2005
	(In Thousands, Except Per Share Data)				
Consolidated Statement of Operations Data:					
Net sales	\$ 22,989	\$ 36,968	\$ 62,576	\$ 133,225	\$ 194,472
Gross profit	17,691	29,216	48,900	103,904	149,726
Distributor commissions	12,449	16,834	27,555	68,579	101,021
Selling, general and administrative expenses	5,187	10,710	15,770	33,102	49,000
Provision for KGC receivable					2,759
Income (loss) from operations	(65)	238	5,575	2,223	(3,054)
Net income (loss)	466	2,139	4,728	1,241	(5,502)
Diluted income (loss) from continuing operations per share <sup>1</sup> :					
	\$ (0.98)	\$ (0.11)	\$ 0.83	\$ 0.18	\$ (0.79)
Diluted weighted-average number of shares outstanding <sup>1</sup> :					
	1,342	3,118	5,688	6,822	6,934
Consolidated Balance Sheet Data (at end of period) <sup>2</sup> :					
Cash and cash equivalents	\$ 324	\$ 3,864	\$ 11,133	\$ 22,324	\$ 18,470
Working capital	(4,858)	(1,187)	2,889	17,519	11,296
Total assets	3,075	10,319	20,340	62,105	63,315
Total debt	1,021	684	199	818	109
Total stockholders' equity (deficit)	(4,370)	(398)	4,824	37,029	36,536

<sup>1</sup> All share and earnings per share data gives effect to a 1-for-100 reverse stock split, which took effect in March 2003.

<sup>2</sup> The Company sold its 51% equity interest in KGC effective December 31, 2005. As a result, its

balance sheet  
was not  
included in the  
Company's  
consolidated  
financial  
statements at  
December 31,  
2005.



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**Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Business Overview**

The Company is an international direct selling organization. We control subsidiaries that distribute products through two separate direct selling businesses that promote health, wellness and vitality. Our wholly-owned subsidiary, Lexxus U.S., and other Lexxus subsidiaries, sell certain cosmetic products, consumer as well as quality of life products, which accounted for approximately 96% of our consolidated net revenues in 2003 and 99% in each of 2004 and 2005. eKaire.com, Inc. ( eKaire ), our wholly-owned subsidiary, distributes nutritional supplements aimed at general health and wellness.

Lexxus commenced operations in January 2001 and has experienced tremendous growth. As of December 31, 2005, it is conducting business in at least 15 countries through approximately 119,000 active distributors, excluding KGC (see discussion below). eKaire has been in business since 2000 and is operating in four countries through approximately 3,000 active distributors. We consider a distributor active if they have placed at least one product order with us during the preceding year.

We have experienced significant revenue growth over the last few years due in part to our efforts to expand into new markets. We do not intend to devote material resources to opening any additional foreign markets in 2006. Our priority for 2006 is to progress further on developing the Japanese, Mexican and Chinese markets.

In 2005, we generated approximately 92% of our revenue from outside North America, with sales in Hong Kong representing approximately 62% of revenue. Because of the size of our foreign operations, operating results can be impacted negatively or positively by factors such as foreign currency fluctuations, and economic, political and business conditions around the world. In addition, our business is subject to various laws and regulations, in particular regulations related to direct selling activities that create certain risks for our business, including improper claims or activities by our distributors and potential inability to obtain necessary product registrations.

Effective December 31, 2005, the Company entered into a Stock Purchase Agreement with Bannks Foundation ( Bannks ), a Lichtenstein foundation and owner of 49% of the common shares of KGC Networks Pte Ltd. ( KGC ), a Singapore corporation, pursuant to which the Company sold to Bannks 51,000 common shares representing the Company's 51% of the outstanding shares of capital stock of KGC for a total cash purchase price of \$350,000.

At the same time and as a condition of the sale, the Company entered into a separate agreement whereby KGC would pay to the Company 24 monthly payments of approximately \$169,000 each, including interest at 2.5%, to