



Lululemon: A Sheer Debacle in Risk Management

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INTRODUCTION

Risk management is the process by which an organization anticipates and mitigates its exposure to adverse outcomes. Risk management generally involves identifying the full set of events that have the potential to disrupt a company's strategy or operations, estimating the likelihood of their occurrence, and taking steps to minimize their impact—either through prevention or a prepared response.

Boards and managers broadly recognize the importance of risk management. According to the National Association of Corporate Directors (2014), "risk" ranks third on the list of topics that boards spend the most time discussing, after strategy and financial reporting.¹ And yet recognizing the importance of risk management is not the same as effectively managing risk. In practice, companies often fall short not because they fail to anticipate the likelihood that adverse events occur but because, *despite anticipating them*, they are still ill-prepared to respond. As illustration, consider the case of Lululemon which struggled to respond to anticipated product quality issues and contain the fallout on social media.

LULULEMON AND RISK

On March 18, 2013, Lululemon Athletica pulled from its stores its inventory of women's black yoga pants made from the company's proprietary Luon fabric because recent shipments did not meet the company's specifications. According to a press release:

The ingredients, weight and longevity qualities of the pants remain the same but the coverage does not, resulting in a level of sheerness in some

*of our women's black luon bottoms that falls short of our very high standards.*²

Approximately 17 percent of its inventory of women's pant bottoms was affected. Lululemon stock fell 3.8 percent on the news.

For a company reliant on a reputation for quality, the news was significant. Founded in 1998 by Dennis "Chip" Wilson, Lululemon carefully positioned itself as a high-end purveyor of women's fitness apparel. CEO Christine Day, who joined the company in 2008, furthered this approach through a strategy of "planned scarcity": the company intentionally kept key products in short supply to boost demand. Lululemon also fostered relations with yoga and fitness instructors, earning the imprimatur that comes through affiliation with professionals. As a result, the company successfully cultivated a "lifestyle brand," which allowed it to charge high prices—upwards of \$100 for a standard pair of yoga pants—and generate annual sales per square foot of \$2,000, exceptionally high figures for a retailer and ranking third highest in the United States after Apple and Tiffany.³

Lululemon was cognizant of the risks facing its operations. In a form 10K, filed the previous year with the SEC, Lululemon warned of its reliance on a limited number of suppliers:

Many of the specialty fabrics used in our products are technically advanced textile products developed and manufactured by third parties and may be available, in the short-term, from only one or a very limited number of sources. For example, luon fabric, which is included in many of our products, is supplied to the mills we use by

a single manufacturer in Taiwan, and the fibers used in manufacturing luon fabric are supplied to our Taiwanese manufacturer by a single company.

The company also knew that supply chain issues could disrupt its operations:

We may experience a significant disruption in the supply of fabrics or raw materials from current sources.... Additionally, if defects in the manufacture of our products are not discovered until after such products are purchased by our guests, our guests could lose confidence in the technical attributes of our products and our results of operations could suffer and our business could be harmed.

The company also recognized the importance of its brand to its overall success, as well as the role that social media played in supporting that brand:

Our success depends on the value and reputation of the lululemon athletica brand.... We rely on social media, as one of our marketing strategies, to have a positive impact on both our brand value and reputation. Our brand could be adversely affected if we fail to achieve these objectives or if our public image or reputation were to be tarnished by negative publicity.⁴

Still, despite having identified these risk factors in advance, the company was not prepared to manage them when they materialized.

PRODUCT RECALL AND FALLOUT

Unbeknownst to the broad financial community, the problem with excessively sheer Luon pants did not begin with the product recall. For months, customers and Lululemon enthusiasts complained on blogs, social media websites, and the product review section of the lululemon.com website about quality issues with the company's fabric:

I tried both Astro Wunder Unders and while the colors and fit are awesome, they are SO see through.... The fabric was way thinner than my other Wunder Unders and felt cheaper and less soft.⁵

Wandering Yogi crops were completely unacceptable. It wasn't just my underwear that showed through; you could see the color of my flesh!⁶

I can't believe they're calling this Luon. It feels like cheap drugstore pantyhose, and it looks just about as sheer. This is nothing like the Luon of the past. Why does online help absolutely insist that the Luon hasn't changed?⁷

In recalling the pants, the company initially blamed its supplier for not meeting "technical specifications." The supplier, however, disputed this claim: "All shipments to Lululemon went through a certification process which Lululemon had approved. All pants were manufactured according to the requirements set out in the contract with Lululemon."⁸ CEO Christine Day later clarified that the problem was not due to production but to inadequate testing:

The truth of the matter is, the only way that you can actually test for the issue is to put the pants on and bend over... It passed all of the basic metric tests and the hand feel is relatively the same. So it was very difficult for the factories to isolate the issue, and it wasn't until we got in the store and started putting it on people that we could actually see the issue.⁹

Analysts questioned whether the company had adequate controls. According to a report by Sterne Agee: "We are concerned that [Lululemon] does not have the appropriate presence in and around its factories.... It appears that there is not appropriate oversight in place."¹⁰ To rectify this, the company announced several steps to improve product quality, including greater oversight of suppliers, improved testing, and leadership and organizational changes. Sheree Waterson, chief product officer, would step down. The company estimated that its inventory of black Luon yoga pants would be fully in stock within 90 days.

By June, Lululemon succeeded in returning Luon pants to its shelves. While it would take time to build inventory to normal levels, the company was clear that the newly stocked product met heightened testing standards:

We put the fabric through a total of 15 tests addressing specific components of the fabric.... We have adjusted the shape of the pattern to ensure that the fabric will fit the body without being stretched beyond its capability. This includes consideration for both vertical and horizontal stretch.

The company asserted that “our quality testing has never been better than it is now.”¹¹

The matter, however, did not end there. In June 2013, Christine Day announced her resignation as CEO; she would remain in her position until a permanent successor was identified. No reason was given for the move, other than her statement that, “This was a personal decision of mine. It’s never a perfect time to leave a company you love.”¹² Lululemon stock fell 17.5 percent on the news, wiping out \$2 billion in market value in a single trading session. During her five-and-a-half year tenure with the company, Day had grown sales by a factor of five and profits by a factor of nine. Investors were worried about what the move implied about the company’s future. Adding to problems, the *Wall Street Journal* reported that Chairman Chip Wilson sold \$50 million in Lululemon stock through pre-arranged 10b5-1 trading plans just four days before the announcement of Day’s resignation was made public and *the same day* that Day informed the board of her decision.¹³ According to his assistant: “Mr. Wilson has had no influence on trades conducted by Merrill Lynch pursuant to either of these plans. Any suggestion of impropriety by Mr. Wilson is inaccurate and irresponsible.”¹⁴ Lululemon was hit with two shareholder lawsuits.

Worse, despite Lululemon’s assurance that “quality testing has never been better,” complaints about product quality did not go away. Customers flooded the company’s website and Facebook page claiming that the pants were still too sheer. In one post, a customer demonstrated how transparent her pants were by taking a photograph of the view through her window as seen through the pants and posting it on the lululemon.com website (see Exhibit 1). Customers also complained about pilling—the tendency for tiny balls of fabric to form on the surface of the pants.

Rather than apologize, the company defended its product quality:

*The majority of feedback about the return of our black luon bottoms has been positive and our luon is meeting all of our updated quality standards. We’re seeing a few negative comments online which may be because guests don’t have the benefit of doing an in-store fit session with one of our educators to make sure the fit is right for them.*¹⁵

In a television interview, Wilson suggested that the problem lay with customers rather than the product:

*The thing is that women will wear seatbelts that don’t work [with the pants], or they’ll wear a purse that doesn’t work, or quite frankly some women’s bodies just actually don’t work for it. They don’t work for some women’s bodies. It’s really about the rubbing through the thighs, how much pressure is there over a period of time, how much they use it.*¹⁶

The reaction on social media was intense. Wilson later posted an apology on YouTube, but it only served to make matters worse. Wilson’s apology was stilted and included no explicit remorse for the offense he gave with his comments. His message also appeared to be directed to employees rather than customers:

*I’m sad, I’m really sad, I’m sad for the repercussions of my actions, I’m sad for the people of Lululemon who I care so much about, that have really had to face the brunt of my actions. I take responsibility for all that has occurred and for the impact it has had on you. I’m sorry to have put you all through this. For all of you that have made Lululemon what it is today, I ask you to stay in a conversation that is above the fray. I ask you to prove that the culture that you have built cannot be chipped away. Thank you.*¹⁷

An ABC News report asked, “Is Lululemon chairman’s apology the worst ever?”¹⁸

The bad news continued, again amplified by social media. Rumors circulated that the company purposefully discouraged plus-size women from

purchasing its products by keeping its inventory of larger sizes in low supply and stocking them in the back of stores. Photographs were shared online of a store in Maryland that attempted to make light of the situation with a window display that read: “Cups of Chai / Apple Pies / Rubbing Thighs?” The company issued another apology (see Exhibit 2).

In December, the company lowered profit guidance because of a “meaningful” slowdown in store traffic.¹⁹ CFO John Currie told analysts that the company’s many PR issues “undoubtedly” impacted business:

I think any time there is negative PR for a company there is an impact on the business. And I’m not saying we can see a one-for-one correlation but, let’s face it, we have had lots of PR issues this year.²⁰

The company announced that Laurent Potdevin, former manager at LVMH Moët Hennessy Louis Vuitton and president of Toms Shoes, would succeed Christine Day as CEO. Chip Wilson stepped down as chairman of the board, but remained a director. In June 2014, Wilson again made news by voting against the reelection of two fellow board members at the company’s annual meeting. The company issued another profit warning, and CFO John Currie announced his resignation (see Exhibit 3).

WHY THIS MATTERS

1. Companies disclose an extensive list of risk factors in SEC filings. However, there is often a disconnect between identifying risks in advance and being prepared to manage them when they materialize. How can companies implement a risk management program that is actually *effective* in reducing risk?
2. How can senior management and members of board of directors satisfy themselves that a company has a reliable way to track and respond to strategic risks? What type of analysis and reporting would provide this assurance?
3. The case of Lululemon demonstrates the power of social media to propagate customer complaints, and the significant impact this can have when a company fails to respond in a constructive manner. How can companies better manage their social media presence? How should information about customer sentiment be shared internally? Who should be responsible for managing the response?
4. How can senior management and members of the board satisfy themselves that a company has a reliable way to track and respond to *social media* risk? What types of analysis and reporting should they rely on?
5. Lululemon’s handling of the Luon recall, quality issues, and related reputational damage involved a considerable number of miscues. When do risk-related matters become a board-level issue? At what point should the board of directors directly intercede to monitor or manage a company’s response? ■

¹ National Association of Corporate Directors, “NACD Public Company Governance Survey,” (2013-2014).

² Lululemon Athletica, “Black Luon Pants Shortage Expected,” press release (March 18, 2013).

³ Beth Kowitt and Colleen Leahey, “Lululemon: In an Uncomfortable Position,” *Fortune* (September 16, 2013).

⁴ Lululemon Athletica, form 10-k, filed with the SEC (March 22, 2012).

⁵ Anonymous comment (June 7, 2012), Lululemon Addict blog, “Astro Wunder Unders, Sun Runner SS, Daily Gym Bag, and More,” (June 7, 2012).

⁶ Style in Motion blog, “Review: Wandering Yogi Crop,” (June 26, 2012).

⁷ Anonymous comment on lululemon.com, cited in: “Long-Time Lululemon Devotees Say See-Through Pant Problem Is Nothing New,” *Fashionista* (March 20, 2013). Edited for clarity.

⁸ Aries Poon and Karen Talley, “Yoga-Pants Supplier Says Lululemon Stretches Truth,” *The Wall Street Journal* (March 20, 2013).

⁹ Lululemon Athletica, “Q4 2012 Lululemon Athletica Earnings Conference Call,” CQ FD Disclosure (March 21, 2013).

¹⁰ Sterne Agee, “On A Sheer Day You Can See Forever?” (March 21, 2013), accessed via Thomson One.

¹¹ Lululemon Athletica, “Black Luon Pants—FAQ,” (March 2013; updated, November 5, 2013).

¹² Serena Ng, “Lululemon Searches for a New CEO,” *The Wall Street Journal* (June 11, 2013).

¹³ 10b5-1 plans are designed to protect executives with material non-public information from allegations of insider trading. Under SEC Under Rule 10b5-1, insiders are allowed to enter into a binding contract that instructs a third-party broker to execute purchase or sales transactions on behalf of the insider. The contract can be agreed to only during a period in which the insider does not have knowledge of material nonpublic information. The insider is required to specify a program or algorithm that dictates the conditions under which sales are to be made; such factors might include the number of shares, the interval between transactions, or a share price limit. After the third-party broker receives his or her instructions, the insider is not allowed to exercise any influence over the execution of the plan and the third-party broker has sole discretion to execute trades. See: David F. Larcker and Brian Tayan, “10b5-1 Plans: Mortgaging

a Defense Against Insider Trading,” Stanford GSB Case No. CG-10 (November 9, 2007).

¹⁴ Suzanne Kapner, “Timing Aids Lululemon Insider,” *The Wall Street Journal* (June 13, 2013).

¹⁵ Lululemon Athletica, “Black Luon Pants—FAQ,” *loc. cit.*

¹⁶ Bloomberg Television, “Lululemon Pants Don’t Work for Some Women: Founder,” (November 5, 2013).

¹⁷ Chip Wilson, “A Message From Chip Wilson,” YouTube (November 8, 2013), available at: <https://www.youtube.com/watch?v=jeFMeBtNRp8>.

¹⁸ “Is Lululemon Chairman’s Apology the Worst Ever?” ABC News (November 14, 2013).

¹⁹ Suzanne Kapner and Ben Fox Rubin, “New Year Casts a Chill on Lululemon,” *The Wall Street Journal* (January 14, 2014).

²⁰ Lululemon Athletica, “Q3 2013 Lululemon Athletica Earnings Conference Call,” CQ FD Disclosure (December 12, 2013).

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EXHIBIT 1 — ONLINE POST ABOUT PRODUCT QUALITY



“See for yourself with the photo I uploaded - this is a picture taken through the pants. For. Real.”
– November 2013

Source: Reproduced in: Michelle Chapman, “People Are Still Complaining Lululemon’s Pants Are Too Sheer,” *Huffington Post*, (November 1, 2013).

EXHIBIT 2 — DISPLAY WINDOW IN MARYLAND STORE



Diana Russell
@russresearcher

Follow

@BethesdaRow Have you seen this? Ugh:-(For a variety of reasons, won't be shopping here and decidedly NOT a size 10!

1:24 PM - 2 Dec 2013

13 RETWEETS 6 FAVORITES



lululemon athletica ✓
@lululemon

Follow

@MilaMimica1 We're deeply sorry, the display is being taken down. We celebrate that thighs rub together- ours do too.

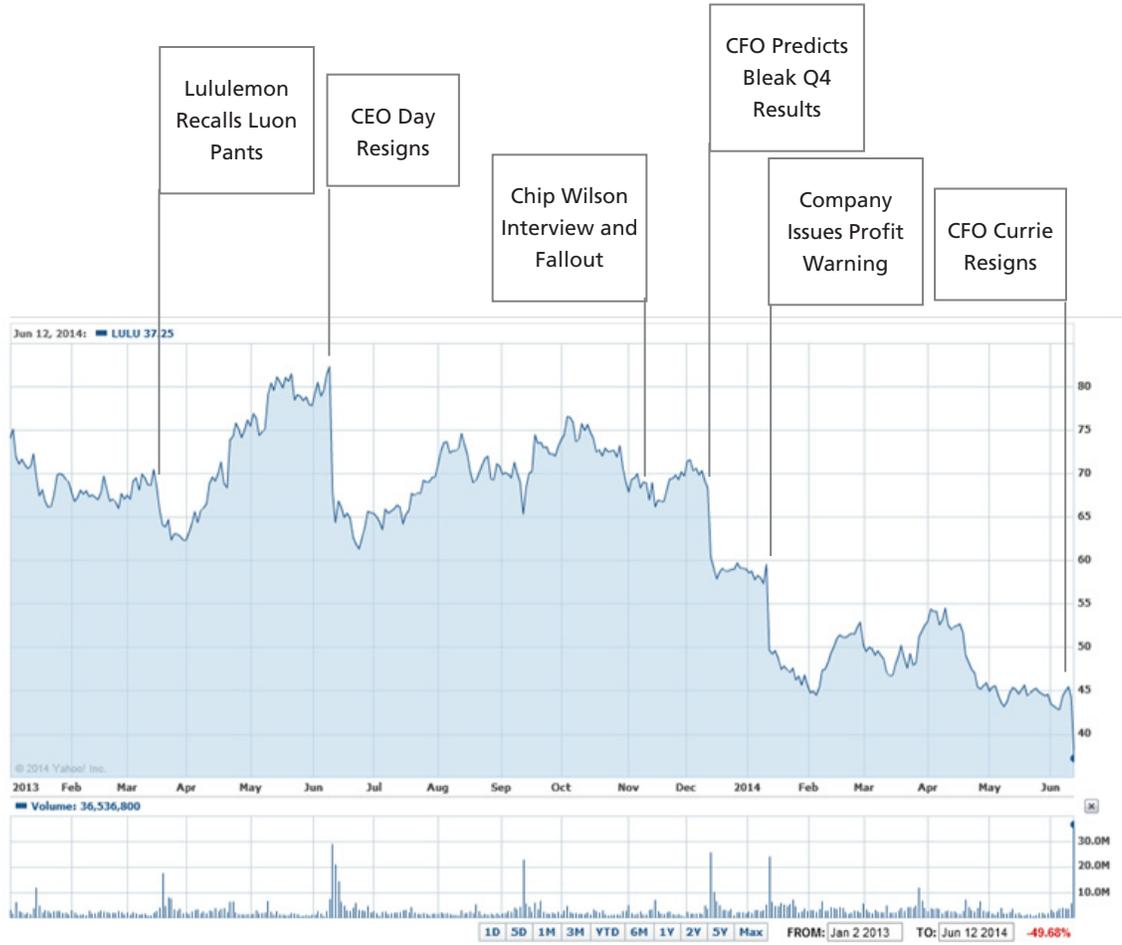
3:31 PM - 2 Dec 2013

2 RETWEETS 2 FAVORITES



Source: Lululemon Athletica, Facebook (December 2, 2013).

EXHIBIT 3 — STOCK PRICE HISTORY AND SELECTED EVENTS



Source: Yahoo! Finance.