Federal Court Sees Through Sheer Allegations in Dismissing Lululemon Securities Class Action

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Last week, the United States District Court for the Southern District of New York dismissed a securities class action (as well as a parallel derivative lawsuit) arising out of alleged quality control issues at our client, lululemon athletica, inc. ("lululemon"). The claims related to lululemon's widely reported decision in March 2013 to pull its signature black yoga pants from stores due to an unacceptable level of sheerness. The Court's 54-page opinion should be helpful to defendants ensnared in class action securities litigation for its in-depth treatment of a variety of critical issues, including the standards for alleging the falsity of opinion statements, scienter, and causation. In short, the Court saw through a barrage of confidential witness allegations and held that the plaintiff had not pled a coherent or compelling theory of fraud in connection with lululemon's product quality setback and a loss of earnings momentum.

The plaintiff attacked dozens of statements from lululemon's SEC filings, press releases, website postings, and quarterly earnings calls touting the company's belief in the high quality of its product. The plaintiff relied on assertions from 11 so-called confidential witnesses – all former lululemon employees – and substantial stock sales by the company's founder and by its then-CEO.

Falsity. The Court found plaintiff's falsity allegations "fatally deficient" because they took statements out of context that revealed the statements to be "at most non-actionable statements of opinion or belief." Op. at 32. The Court explained that "it is the facts known to, and the intent of, the maker of the statement which is ultimately relevant when the Court considers the falsity of statements of belief or opinion" (Op. at 38) and refused to credit eleven confidential witnesses who neither made the challenged statements nor were involved in the discovery or disclosure of the sheerness issue in March 2013.

Scienter. The Court next rejected all nine of plaintiff's scienter theories, finding it "more reasonable and likely that a publicly traded company, which touts quality as a centerpiece, will want to rectify any quality issues as quickly as possible since quality issues would be (and were) immediately apparent and directly affected sales" and "far less likely (and certainly not cogent and compelling) that the need for quality in order to maintain its brand would lead a company to make intentionally false statements regarding its remediation of quality problems, since doing so could only result in inevitable discovery with defective products on the shelves." Op. at 43-44. The Court also held that defendants' "considerable" stock sales during the class period did not support an inference of scienter because the sales were consistent with defendants' past trading practices or were made pursuant to a non-discretionary Rule 10b5-1 trading plan.

Loss Causation. The Court finally held that "[t]he number of dots the Court must connect to produce an adequate theory of loss causation are too numerous and attenuated to succeed" (Op. at 49) and rejected plaintiff's attempt to construct a 16-month fraudulent scheme extending through the disclosure of the sheerness issue in March 2013, the resignation of the company's CEO in June 2013, and the company's reductions to its earnings guidance and its updates on quality control improvements in the latter months of the alleged class period.

Key Take-Aways

This decision highlights important concepts in defending against the securities class actions that routinely follow a public company's announcement of "bad news."

First, the Court reiterated the longstanding principle that the securities laws are not meant to address business setbacks, and that courts will not "stretch allegations of, at most, corporate mismanagement into actionable federal securities fraud." Op. at 2.

Second, the decision reaffirms that Rule 10b5-1 trading plans provide a cognizable defense to scienter allegations premised on insider trading. Even a trading plan entered into during the alleged class period can provide a defense where the plaintiff has failed to allege that the defendant executed the plan "to capitalize on insider knowledge." Op. at 49.

Third, the Court's careful examination of each of the numerous allegations ascribed to the 11 confidential witnesses shows that this popular pleading tactic will not prevent dismissal where the confidential witnesses fail to "set[] forth facts that suggest that any of the alleged statements were false when they were made." Op. at 37.

Most important, the decision reflects the Court's refusal to leave common sense at the courthouse door in evaluating the sort of knee-jerk securities fraud claims that follow the disclosures of business mishaps that every public company encounters. As the Court explained, given the intended use of lululemon's product, it simply made no sense that a company with a business model based on high quality would risk its reputation by knowingly or recklessly stocking "sheer" yoga pants in its stores – all the while misleading the public about the company's product quality – rather than attempting to rectify any quality problem immediately upon discovery.

The Weil team was led out of New York by partners Joseph Allerhand and Stephen Radin, and associates Caroline Zalka, Layne Behrens, Robert Ruff, and Larkin Kittel.

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