

Lumber Liquidators: Rebuilding the business from the floor up

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Background

In the early morning of May 21, 2015, Lumber Liquidators Holdings Inc. (stock ticker LL: NYSE) announced the abrupt resignation of its CEO, Robert M. Lynch. The news led to a 15% plunge of LL's stock on NYSE¹. While Mr. Lynch's departure was unexpected, there was more to come. The company would have to confront unprecedented external challenges.

Lumber Liquidators was founded by Tom Sullivan, a building contractor, in 1994 when he started buying and selling excess wood that other companies did not need from the back of his truck. Initially the company specialized in hardwood flooring. LL had expanded its portfolio to include engineered hardwoods, laminate flooring, exotic hardwood flooring and other flooring products. Based in Toano, Virginia, the company pursued a low-cost business model by eliminating middlemen and sourcing selectively. Aggressive discounting and volume were key to effective execution of this strategic posture. LL had opened 354 stores in 46 states and Canada and had 1,844 full time employees².

In its 2015 Q1 report, LL had disclosed to its stockholders the possibility of criminal charges by the US Justice Department³, following allegations that its laminate wood flooring contained dangerous levels of cancer-causing formaldehyde. The report in part stated that,

“While our suppliers agree to operate in compliance with applicable laws and regulations, including those relating to environmental and labor practices, we do not control our suppliers. Accordingly, despite our continued investment in quality control, we cannot guarantee that they comply with such laws and regulations or operate in a legal, ethical and responsible manner”.

As early as 2011, consumers had raised complaints about the odor, irritation and respiratory problems after installing LL's flooring⁴. Other complaints were in regard to the quality of the flooring material and customer service. Some activist consumers and hedge fund managers had gone to the extent of conducting their own formaldehyde tests on LL's flooring products. Environmental groups and consumer advocates were also beginning to take notice.

The formaldehyde issue seemed to have ignited other problems at LL. On November 26, 2013, a shareholder, Gregg Kiken, filed a securities fraud lawsuit against LL. In the suit, the claimant

¹ Mathew Townsend, “Lumber Liquidators CEO Abruptly Quits Amid Probe of Flooring”, Bloomberg, May 21, 2015

² S & P Capital IQ Tearsheet Report (<https://www.capitaliq.com/CIQDotNet/company.aspx?companyId=4373805>), accessed on June 9, 2015; Lumber Liquidators (<http://www.lumberliquidators.com/ll/flooring/about-us>)

³ 10-Q Report, 2015, Lumber Liquidators Holdings Inc., April 29, 2015

⁴ Reseller Ratings, http://www.resellerratings.com/store/Lumber_Liquidators

was seeking compensation for illegal importation of certain wood products and elevated levels of formaldehyde in other products⁵. There was increased chatter among stock analysts and hedge fund managers on the fundamentals behind LL's performance and valuation. By April 27, 2015, there were 103 pending class action lawsuits in various U.S. federal district courts and state courts relating to its laminate flooring manufactured in China. These cases were based on false advertising, breach of warranty, negligence, fraud, unfair and deceptive business practices.

In the recent past, LL had been the focus of environmentalists and regulators regarding the sourcing of its imported flooring products and the quality of these products. By September 26, 2013, LL was being investigated by the Department of Homeland Security's Immigration and Customs Enforcement and the U.S. Fish and Wildlife Service for violation of the Lacey Act. By 2015, the Department of Justice was seeking criminal charges against LL.

Formaldehyde and CARB 2

Formaldehyde is a colorless, reactive, strong-smelling gas at room temperature. Formaldehyde can be released into the air from materials and products containing it. The core board of laminate flooring is made of various materials, including wood, is often glued together with an adhesive that often includes formaldehyde. Formaldehyde is also used as a preservative in mortuaries and medical laboratories⁶. Cohort studies by the National Cancer Institute had shown that exposure to formaldehyde increased the risk of cancer, specifically myeloid leukemia. There were a number of federal regulations pertaining to formaldehyde and how it was used in flooring products. However, there were no federal regulations to guide how the testing should be conducted. California Environmental Protection Agency had been at the forefront in pioneering these standards, and the regulation read in part, "any composite wood products contained in flooring products – generally the underlying platform to which the laminate or wood veneer is affixed – are required to be certified as complying with California's formaldehyde emission standards. Companies that make flooring are required to label their flooring or their boxes of flooring as having been made with certified compliant composite wood products, to keep records to verify that they have purchased compliant products, and to inform distributors and retailers that their flooring is compliant with California's current requirements (referred to as CARB Phase 2)⁷". Responding to one customer complaint, LL's response appearing in the June 20, 2013 issue of *Seeking Alpha*⁸ was as follows,

"The adhesive that is used in bonding our Bamboo, Cork, Engineered, and Laminate flooring products contain very low amounts of Urea Formaldehyde. We feel that our products are very safe and most meet California CARB Phase I or California Phase II regulations, which is listed on the boxes. We also list MSDS sheets for most of these products on the Lumber Liquidators website "Flooring 101."

⁵ Ryan Abbott, "Class of Shareholders Sues Lumber Liquidators", Courthouse News Service, December 4, 2013

⁶ "Formaldehyde and Cancer Risk", National Cancer Institute, <http://www.cancer.gov/about-cancer/causes-prevention/risk/substances/formaldehyde/formaldehyde-fact-sheet>

⁷ California Environmental Protection Agency, http://www.arb.ca.gov/toxics/compwood/consumer_faq.pdf

⁸ Xuhua Zhou, Illegal Products Could Spell Big Trouble At Lumber Liquidators, *Seeking Alpha*, June 20, 2013

In response to allegations of excessive formaldehyde levels in homes that had installed LL's laminate floors, LL had shipped do-it-yourself test kits for customers to measure the air quality in their homes. However, the Environmental Protection Agency had rendered a position that the tests may not provide useful information due to the uncertainties of the method⁹.

The Lacey Act

An issue that had received little public attention was related to the sourcing of LL hardwood products. Some environmental groups including Environmental Investigation Agency (EIA)¹⁰, had long suspected LL of importing illegally sourced Russian hardwood through Chinese flooring manufacturers. In the Russian Province of Khabarovsk, a valuable habitat for a wide range of flora and fauna, including the Siberian tiger, illegal logging was an endemic problem. Illegal logging concessions were made possible by bribery and corruption of Russian and Chinese officials, in collusion with local timber companies. The EIA report had made claims that the head of LL's sourcing operations had even visited sawmills in the Russian Far East.

The exotic hardwood flooring was eventually imported into the US by LL, a violation of the Lacey Act¹¹ that forbids illegal imports of illegally logged woods into the US. Companies that had contravened the Lacey Act would be likely to face scrutiny on related laws such as Foreign Corrupt Practices Act, Child and Forced Labor Prohibitions and Federal Trade Commission labeling rules.

Unintended Consequence of good performance

From a performance perspective, 2013 was a special year for LL. The company delivered a net sales growth of 23% compared to 15.8% by similar competitors; a gross margin of 41.1%; an operating margin of 12.6% and a net income increase of 64.4%¹². During this period, the stock price increased from \$18.84 to \$99.42¹³. According to LL's 2013 annual report, this performance was in part attributed to a rollout of new stores, a new sourcing strategy and supply chain optimization. Analysts argued that LL was in a fierce commodity market with established competitors such as Lowe's and Home Depot and a market share of only 10.2%. These observations, in addition to the pending lawsuits, led the analysts to the opinion that LL's stock was significantly overvalued. In a 60 Minutes interview¹⁴, LL was to claim that hedge fund managers were only interested in shorting LL's stock. The sale of LL stock by its founder Tom Sullivan and CEO Robert Lynch in 2013 when LL stock was on a growth trajectory was not a significant matter at that time.

⁹ Mathew Townsend, "Lumber Liquidators' Home-Testing Methods Get EPA Scrutiny", Bloomberg, June, 5, 2015

¹⁰ "Liquidating the forests: Hardwood Flooring, Organized Crime and the World's Last Siberian Tigers", Environmental Investigation Agency, 2013

¹¹ Lacey Act, US Fish and Wildlife Service, <http://www.fws.gov/e/pdffiles/Lacey.pdf>

¹² Lumber Liquidators, 2013 Annual Report

¹³ NYSE, <https://www.nyse.com/quote/XNYS:LL>

¹⁴ "Lumber Liquidators linked to health and safety violations, 60 Minutes, March 1, 2015, <http://www.cbsnews.com/news/lumber-liquidators-linked-to-health-and-safety-violations/>

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The following is a chronological timeline of key events that had led to LL's situation:

- **2011:** Consumer complaints of formaldehyde levels in LL's flooring begin to emerge.
- **September 2013:** DOJ opens investigation for LL's violation of Lacey Act.
- **October 2013:** Environmental Investigation Agency, an environmental group, releases a dossier documenting illegal sourcing of hardwood from protected Russian habitats by LL through its Chinese suppliers.
- **November 2013:** A shareholder, Gregg Kiken, files a securities fraud lawsuit against LL.
- **November 2013:** LL stock hits the highest level of \$119.
- **March 2015:** 60 Minutes airs a damning report on high formaldehyde levels in LL's products.
- **April 2015:** There is a total of 103 pending class action lawsuits against LL.
- **May 2015:** Robert Lynch, CEO, resigns.
- **June 2015:** Daniel Terrell, CFO, departs company.
- **June 2015:** Ray Cotton, Chief Compliance Officer, departs company.
- **June 2015:** William Schlegel, Chief Merchandising Officer, departs company.
- **August 2015:** 60 Minutes airs a follow up of its initial report on LL.
- **August 2015:** LL hires Jill Witter as Chief Compliance & Legal Officer.
- **August 2015:** LL stock price is hovering at \$15.

As if multiple allegations of ethical and criminal misconduct were not enough, LL was dealing with a consumer backlash, especially in the state of California. In addition to the abrupt departure of LL's CEO, the Chief Financial Officer, and the Chief Compliance Officer had recently left the organization. Thomas D. Sullivan, the company's founder would serve as the acting Chief Executive in the interim.

As he signed off the press release, Mr. Sullivan started pondering how to prioritize the issues confronting LL in order to regain trust by customers and fulfill his goal of becoming the industry's leader in sustainability.

Your firm has been hired to assess the situation and make a recommendation to the founder of LL. You have been asked to address the ethical challenges facing Mr. Sullivan and provide solution(s) to develop ethical practices to restore the trust of customers and its corporate reputation.

HINTS

- *What factors might have caused LL to fall into ethical problems?*
- *What are the main ethical challenges confronting LL performance in the business environment?*
- *Consider the most relevant factors in the external environment that are pertinent.*
- *Who are the stakeholders involved and what are their primary interests?*