

A Podcast Series in Collaboration With PLUS

In the Boardroom with Resnick and Fuller

Episode 10

Featuring Stephanie Resnick and John Fuller

PLUS: Today, in Episode One, we focus on two shareholder lawsuits that illustrate the impact of COVID on the responsibilities of board members and how the unprecedented disruptions brought on by the pandemic can be used against Directors and Officers by investors who claim they were misled about what to expect. Before we get started, I'd like to introduce both of our speakers.

Stephanie Resnick is a partner at Fox Rothschild, a national law firm, and is co-chair of the firm's Directors' and Officers' Liability and Corporate Governance Practice Group. For 14 years, Stephanie has been ranked by Chambers USA as a leading litigator in Pennsylvania. She's known for taking the lead in high stakes, bet-the-company litigation and defending corporate boards and officers in complex and protracted litigation. Stephanie is a former managing partner of Fox's Philadelphia office and a past chair of its nationwide Litigation Department.

John Fuller is also a partner at Fox Rothschild and is the other co-chair of the firm's Directors' and Officers' Liability and Corporate Governance Practice Group. John has extensive experience defending directors and officers of public and private corporations in claims stemming from the discharge of their duties and management decisions. Since 2015, Stephanie and John have been co-authoring articles on topics of interest to corporate boards and directors for a variety of publications, including Corporate Compliance Insights, The Legal Intelligencer, and the Wiley Board of Leadership Journal.

Fuller: Hello, thank you all for joining us today. We're going to be talking about a couple cases, and what we're seeing right now is sort of a move into a new phase of COVID-related cases. Early on, you know, now, a little over two years ago, when the pandemic first came, and in the aftermath, we saw cases that dealt with companies that were not prepared for the pandemic or did not adapt well to the pandemic, and saw significant financial losses, and shareholders and other interest holders quickly pointed the finger at the board. We're now in a new phase a little over two years later, where we're seeing companies that actually succeeded during the pandemic and had tremendous growth and very positive earnings, but who are struggling with what we're calling the return to normal and the new market in, well, not quite post-pandemic, but in this new phase of the pandemic.

The first case we want to talk about is one involving the Honest Company, which is a brand that focuses on natural and sustainable products. Its board includes the actress Jessica Alba, which has given it some additional notoriety, and it has three principal product categories. The first, diapers and wipes, which was 63% of its annual revenue in 2020; skin and personal care, 26% of revenue; and household and wellness products, including things like disinfectants, which were 11% of its annual revenue in 2020.

Now, Honest is a company, as I said, that saw great growth during the pandemic comparing second quarter performance in 2019 with the second quarter of 2020. The early days of the pandemic saw a 19% growth in its diapers and wipes category. Sort of importantly for this litigation, which has just been filed in the Central District of California, there was some acknowledgement at that point of the pandemic and of what they called stockpiling practices around the pandemic. People likely remember the early days when consumers were concerned about their access to goods and were buying more than they might normally. And it was recognized and understood that was happening and maybe inflating sales to some degree.

However, so this is 2020. The company decides in going into 2021 to look at an IPO and in connection with the IPO, which ended up occurring in May 2021, there are at least a number of different documents and registration statements in which the board of Honest made statements regarding not only its growth and its projections for growth, but about affirmative steps that it was taking to secure secondary suppliers and ensure that it had inventory and support for its continued growth in the view of the supply chains and other things that we were starting to hear in this sort of second wave of COVID were serious challenges. Another thing that happened leading up to the May 2021 IPO was a \$35 million cash dividend in April of 2021 that went out to many of the directors and initial interest holders. And then come forward a few months to August 2021 and Honest issued a press release in which it showed a net loss of \$20 million during its second quarter of 2021. Board identified an estimated \$3.7 million in losses, attributable to a decrease in stockpiling practices in 2021 compared with 2020, but largely was without explanation for the remaining drop in Q2 2021. Now the action, as said, has been brought in the Central District of California. And in this action, the shareholders are asserting claims for breach of fiduciary duty on Justin Richmond and securities violations. Honest has filed a motion to dismiss, which is currently pending, which it argues that statements are not misleading or otherwise actual as insufficient securities disclosures. They raise the point that companies are not required to predict the future. And particularly in this context of an unprecedented global pandemic that they could not possibly have predicted exactly how the market respond and change during these several years.

So with that, you know, [I reached out to] Stephanie Resnick and frankly ask you, Stephanie, you think this case is going to succeed?

Resnick: Well, you know, I look at this case in two parts, John. The first part is the issue as to whether the board can face actionable litigation because they failed to accurately set forth the economic forecast and base it on the prior year, where we were experiencing COVID, and I think that what is really important to note is that the directors and officers do not have to, in my view, predict the future. Sixty—over 60% of Honest’s revenue is derived from environmentally sustainable diapers. And there was no reason to think that the sales would be off simply because COVID had subsided because Honest is competitive with brand names and other brands that are in local drug stores and the like, and there would be no reason to think that people would stop buying that product.

With regard to the sanitizers and the disinfectants, I suppose, the board could have known that, as COVID subsided, individuals would be purchasing less of that product. However, there was no way of the board to know about whether COVID would subside, when it would subside, the degree to which it would subside, and those sorts of things. So I’m a believer that, you know, this particular board of

directors, it would be very, very hard pressed to find against the board, based on their failure to accurately forecast the economic conditions of the company.

Now there's a second issue here. And the second issue is authorizing a \$35 million dividend. When the directors and officers knew that, at least with respect to COVID, we were in flux, and there was a difference. And that, I think, is an issue that is less clear in my mind in terms of whether shareholders would be able to be successful in a lawsuit with regard to that issue. But literally, with respect to predicting sales, future sales and basing it on the prior COVID year, I don't believe that there's any breach of fiduciary duty. Do you agree with me?

Fuller: Well, you know, I think on the dividend, I think I do. I think given the uncertainty and flux to take that amount of money out of the company, not even using hindsight, seems like there could be potential liability, but you know, I think I do see it a little bit differently. As mentioned, it was one thing when you had the big pandemic ascend on the globe and no one had seen it, but now I do think it's a little bit different that we are looking at the market and the market's changed. To your point, it wasn't necessarily a reason to think consumers would stop buying sustainable diapers and that it was purely a COVID-related decision for consumers to pivot to Honest products. But I think there it is incumbent on the board to look at the market, see how the markets change, to understand and have its projections be based on what the market is and will be. And that there is always a risk of not knowing that.

I just, to me, it almost seems that it's a potential excuse that COVID is still here. And I think there is a point if we're not there now, we are going to be there soon, where we are just in a new era and it isn't based on COVID, and the world may have been changed by COVID, but it isn't this unknowable pandemic that excuses all missteps by boards, and maybe I think we're a little closer to that than you do.

Resnick: Yeah, I think so, because I think that that would be a mistake. Directors and officers can only use their reasonable business judgment and so long as they reasonably made a determination with respect to a forecast, I don't see how they could be liable for missing the boat. It's one thing if they didn't take the care and do the due diligence, and it's another thing if they did take the care and do the due diligence to determine that the projection of their sales in a COVID world. I mean, the thing about COVID is that no one knew anything. And it was really a let's see, day by day, including the highest bureaucracy in the United States government and in the world governments. So to impose that duty on a director and officer in my view, if, again, if they had used care and fully considered this issue, I think it would not be a fair result.

Fuller: All right. Well, you know what, I want to bring in this other case too, while we sort of talk through this. And that's a case that was recently filed—a shareholder period of class action in the District Court of Delaware, just in May of 2022, involving the company DocuSign, which is a software company many people are likely familiar with. Sort of most known software that is electronic signature software, which ends with legally binding e-signatures. And as most people probably also know it, it had a huge spike in growth during the pandemic when people were not coming together or finding notaries to close business deals and get significant signatures.

It had seen great growth. And then in December 2021, DocuSign announced that its fourth quarter revenues would be lower than anticipated. It also announced at that time in December 2021, that its 2022 earnings expectations were 50% lower than prior analyst estimates. Now, part of the reason that the board stated for the poor growth is that the pandemic had dissipated faster than anticipated. The shareholders following this announcement, thought that DocuSign's share price fell 42%. Shareholders alleged that this constituted false and misleading statements, because the board had not previously discussed the effect of COVID or its anticipated dissipation, that this constituted misrepresentations about the role of COVID, and downplay of the impact of the return to normal and the impact it would have on DocuSign's growth and its business. And I think this kind of comes back, Stephanie, to this same question of, it's one thing to not understand the effect that the COVID pandemic will have and the shutdowns of businesses, but DocuSign knew someday—or maybe you differ on this—that people may be back in the office. Did their board have a responsibility to restrain its projections?

Resnick: Yeah. John, I think this is very similar to the Honest case. And in fact, I think it's even better positioned because there wasn't a \$35 million dividend that was released by the board or authorized by the board. In this case, I believe that DocuSign had an absolute right to believe that they were cutting edge, progressive, and that DocuSign would maintain the level of its use and revenues because of the nature of the product. The product is such that provides convenience for the parties, saves time, saves money. People don't have to, you know, go to a bank to get something signed and notarized. It's all done electronically, which is a huge development in terms of any type of legal document. So in my view, I think that, again, so long as the board used due diligence, and in this case, I believe they actually hired experts to deal with an economic forecast, which again, puts it ahead of the Honest case. I don't see how the board could be liable for its conduct of doing that. One, again, this is a very progressive product that they had every reason to believe would be an outstanding product. And two, they hired an expert to deal with the economic forecast. So, was it reasonable for the board to rely on an expert?

I'm assuming that the expert was versed and vetted, and the answer is yes. So long as that expert was someone who had the expertise and the proper qualifications in that area to issue an economic forecast, the board could rely on that. You know, again, it's called economic forecast because even the expert, herself or himself, would be forecasting the future. And I don't see how there could be liability as a result, even though the forecast was dramatically different from the actual company results.

Fuller: No, and I, yeah, I certainly agree with you that, you know, it's using the outside experts, provided that they're well vetted, is a good move by the board. I guess one of the things that seems problematic and looking at the complaint in this action—one thing that seems lacking is explanation and sort of clear, causal relationships between the pandemic and the return to normal and the change in DocuSign's performance, I think to your point that it's a product and it's sort of found its place. I think across industries, there's a recognition that work from home or some sort of hybrid is here to stay. There are no places in the complaint where they talk about or sort of give clarity as to whether it's due to competition from other products because of the success of this product, or maybe it's a temporary depression in earnings as people sort of figure out whether they're going to work from home or how that's going to work.

So I think from the plaintiffs' side, there are some holes in terms of pointing and connecting the pandemic, that return to normal and the failures of the company. However, I think on, on the other side,

you know, one of the things that's a challenge for this board is even though they relied on outside experts for this forecasting, they did set benchmarks and missed them by 50%. And I think there is some explanation due there in terms of whatever assumptions were used before. A lot of those assumptions were wrong. And I think that's something we've seen for years, right. In terms of how do you make a credible complaint is to show loss, to show internal benchmarking or external benchmarking and failures to meet those, I think is why a reason that this one could move forward.

Resnick: I think though that when you're looking at those kinds of benchmarks, you have to recognize, and again, I don't think you should completely remove yourself from best practices, which would be running a company in a very conservative way, and understanding that there are these issues that do come about as a result of this world, pandemic in whatever stage it is. I mean, that should have been accounted for somewhat. But again, the fact that they went to experts to do this forecast, even though they missed the mark, I think in this case would insulate the board. I think this is a topic that we could agree and disagree on, only because they missed the mark by a lot. I mean, 50% is a lot, and I think that the real question now is adapting to the new normal, and that means a new market, and there should be considerations as a result of COVID in the marketplace.

Fuller: Yeah. I agree. As I was sort of saying before, and I think we maybe agreed on, is that, you know, if we're not there now, at some point in the future, we're going to be in a post COVID world and, and we are going to be not talking about this, I think in the same way, I don't know, again, if we're there now or we're there in six months or there's a spike in six months and we're back to where we were a year ago. But companies need to figure out how to adjust to this. I think some of the things from these cases that we saw, using outside experts, I totally agree with you is a way for the board, as they always should be doing. If there is something that is beyond their expertise, to get experts and rely on their experts, I agree that they're entitled to do that, but I think, but at the same time, one of the challenges is when the board recognizes or tries to identify things that it is attributing to COVID, like the stockpiling in the Honest case, it can leave you with a space. I guess, you know, \$3.7 million, is attributable to a sort of COVID-related phenomenon, but what about the other \$16 million? And therefore, now you've got a hole of explanations.

Resnick: There's no doubt that best practices would be to identify what the fluctuations that are attributable to COVID or other known unknowns. And again, make sure that you get outside advisors who are true professionals and experts in their field.

Fuller: Yeah. All right. I think we can agree there.

PLUS: Thank you so much to both Stephanie and John. And thank you for listening to this PLUS podcast. Watch the PLUS blog and the PLUS connect app for upcoming episodes of "In the Boardroom with Resnick and Fuller." If you have ideas you would like considered for feature podcasts, visit the PLUS website and complete the PLUS content idea form.