CASE: E438
DATE: 04/10/12

SERENA AND LILY

After spending most of her career working in accounting and technology, Lily Kanter was ready for a change. She had recently spent six years at Microsoft, building out the software giant's retail vertical and helping to launch its first flagship store in San Francisco in 1998 (see **Exhibit 1** for Lily's bio). Though she loved the work, she was exhausted by the travel and decided in 2000 to leave the company to forge her own path. She soon was pregnant with her first child, who was born in June 2001, and shortly thereafter she launched a small foundation focused on a variety of societal issues and community initiatives, including working with social entrepreneurs and introducing technology to inner city youth. While she loved nonprofit work, she had always been an entrepreneur at heart and was motivated to start a business of her own, particularly one that would accommodate her life with young children at home. In July 2002, Lily opened Mill Valley Baby and Kids, a small, specialty boutique in downtown Mill Valley that sold baby and children's apparel, furnishings and accessories.

In October 2003, Serena Dugan, a textile designer and decorative painter, stopped by the shop to drop off her portfolio of work. Lily was at the hospital giving birth to her second child, so Serena left samples of her designs, not expecting a call back for another month or two. Lily swung by the store on the way home from the hospital to check in and came across Serena's work. Excited by the designer's aesthetic, Lily called Serena immediately. The two arranged for a meeting at the store later that week to review Serena's designs and discuss potential projects on

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Certain names and events in this case have been fictionalized.

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which they could collaborate. As Lily described their meeting, "In the first hour I had commissioned Serena to do decorative painting in the store and let me help her sell her artwork for children's rooms to retailers like me. In the second hour, we had identified the opportunity to design crib bedding that we would want in our own nurseries."[1]

THE EARLY DAYS

At the time of Serena and Lily's first meeting, Wendy Bellissimo was among the few crib bedding designers in the market, having established a clear leadership position with representation in over 600 stores nationwide. However, neither Serena nor Lily was attracted to Bellissimo's products, finding them somewhat stale and "grandmotherly". They believed there was a huge opportunity to leverage Serena's talents and introduce a fresher design aesthetic to the baby décor market.

Lily asked Serena to put together a set of idea boards to illustrate her vision for a line of baby bedding that would be compelling to the modern mother. Four weeks later, Serena returned with her boards and Lily was wowed. The duo decided to attend the Atlanta Gift Show—a huge showcase for home décor products—to assess the market and see whether their gut instinct was right. After scouring the show for three days and finding nothing remotely close to what Serena had designed, they were convinced they were on to something big. On the plane ride home, they resolved to start a new company, Serena and Lily, to bring their own personal style to the baby bedding market.

Serena and Lily launched their venture in December 2003 with, as Lily described, "absolutely no idea what we were doing." Despite their self-proclaimed inexperience, by Memorial Day 2004, the twosome had distributed their first catalog to 400 retail stores nationwide, offering a full array of wholesale baby bedding and accessories to retailers not unlike Mill Valley Baby and Kids. In a sheer twist of fate, the very same weekend Serena and Lily's catalog arrived in stores, Bellissimo announced that after seven years in business, she was selling her brand to Babies "R" Us. The timing could not have been more serendipitous. Serena and Lily's fledgling company received 100 orders within two weeks of sending out its catalog.

The cofounders immediately set to work hiring vendors to produce the goods they had showcased so beautifully in their catalog (all of which had been made by a local seamstress in a quantity of one), using money contributed by the cofounders themselves. For the next two and a half years, Serena and Lily ran the company almost single-handedly, with Lily managing all the business-related functions and Serena overseeing creative. They received occasional help from their husbands, along with a small cadre of recent college graduates they had brought on at entry-level salaries to assist with everything from customer service to order processing.

At the end of 2005, their first full year of business, Serena and Lily recorded $750,000 in sales, a number which would double to $1.5 million the following year. They also began to receive celebrity endorsements from the likes of Jennifer Garner, Katie Holmes, Jessica Alba and Monique Lhullier, helping create their reputation as the "go-to crib bedding company in

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[1] Interview with Lily Kanter, February 23, 2012. All subsequent quotations are from this interview unless otherwise noted.

Hollywood". Taking advantage of this momentum, they raised $1.5 million from friends and family in 2007 and launched their second catalog, which introduced children's twin, full and queen bedding. Bolstered by their expanded product line, they anticipated another 100 percent increase in revenue for 2007, an exciting prospect but one which made both cofounders feel that the company's pace of growth would soon outrun their capabilities. With outside funding now in place, Lily set out to hire more experienced, professional individuals to help support the organization in its next phase of growth

MARTA CALFEE

By the end of 2007, Serena and Lily had reached almost $4 million in revenue, with Lily continuing to oversee the business operations and Serena managing creative. Up to this point, Lily, in particular, had been reluctant to hire any accounting or finance staff, reasoning that with her accounting background, she could do it all herself. However, with the business taking off at warp speed, she finally relented and in early 2008, hired Marta Calfee to the position of assistant controller to help manage the company's accounting function.

Marta was an experienced assistant controller who had worked for various companies prior to joining Serena and Lily, including a small technology startup and a retail fly fishing chain in Northern California. Marta jumped in with both feet and fairly quickly took Serena and Lily's accounting function "from kindergarten to high school". She was an incredibly hard worker, always exuded a bright attitude, and by Lily's account, was "scrappy and flexible, in all the best ways". In addition to her accounting role, Marta soon became the de facto head of human resources due largely to her responsibility for managing payroll and because Lily had not yet hired an HR manager. This kind of "roll up your sleeves, let nothing hit the floor" attitude made Marta the perfect fit for the young startup.

Shortly after Marta arrived, Lily hired Hanna Fordiss to manage Serena and Lily's catalog production and circulation, a critical role which would facilitate the company's move towards selling directly to the consumer. Hanna was a long-time, dear friend of Serena's who had worked in catalog circulation for over a decade, experience which made her seemingly well-qualified for the role. Hanna reported directly to Lily, who soon ran up against her new employee's difficult personality. Hanna was reluctant to collaborate or openly share information about the work she was doing, a trait Lily ultimately attributed to Hanna's discomfort with her new role—as it turned out, Hanna had never before managed a marketing budget or worked for a direct-to-consumer business. Though Lily tried multiple tactics to forge a cooperative relationship, Hanna only became increasingly difficult and closed off with each attempt. Finally at the end of her rope, Lily asked Marta if she would be willing to manage Hanna since the two seemed to get along quite well.

Marta readily agreed to the switch. However, despite a previously amicable relationship, she soon also found herself clashing with Hanna. Finally, a major blow-up at the office led Marta and Serena to conclude that Hanna must be let go. To Lily's relief, Marta managed the termination, allowing Lily to stay out of the middle of the messy situation involving one of Serena's closest friends.

With Hanna's departure, there was a void in the catalog circulation function and no one internally with the appropriate experience to fill her shoes. Typical of her style, Marta volunteered to take on Hanna's responsibilities, and assured Lily she would fill the spot when the right person came along. As Marta's responsibilities grew, so did her title and compensation. By 2009, she held the position of senior vice president and her salary had grown from $90,000 to almost $175,000. She continued to be "amazing at holding a lot of balls in the air and she was an incredible generalist." However, she did not have the skills necessary to manage the diverse array of functions underneath her—accounting, human resources and catalog circulation—and she had yet to fill Hanna's role, a source of immense concern for Lily. At the most basic level, Lily had also come to realize that while Marta was a good accountant, she was not skillful at forecasting the cash demands of a complex catalog business, an issue which posed a growing challenge as the company's working capital needs intensified. With 2009 revenues approaching $13 million, Lily began to feel the situation slipping out of control and remembered thinking, "I just can't do this anymore."

After a brief discussion with Serena, Lily immediately resolved to hire the people she knew she should have hired long ago: a CFO, an experienced HR manager and someone who could lead the company's direct-to-consumer marketing efforts, including the web and catalog portions. However, to do so, Lily calculated she would need at least a quarter of Marta's salary to help cover the compensation for the new employees. Additionally, Lily wanted to scale back Marta's inflated responsibilities and title, both to reduce the top-heaviness of the organization and to more appropriately align Marta's skills with her job function. She knew these changes would be difficult for Marta to swallow, but they were critical to establishing a more functional organization going forward. As Lily thought through how to discuss her plan with one of her most trusted employees, she struggled to find a solution that would meet the company's needs while respecting Marta's invaluable hard work, loyalty, and commitment over the past few years.

MALCOLM HENSHAW

By 2008, Serena and Lily was growing by leaps and bounds, and the cofounders set out to raise venture capital financing to allow them to expand the business into its next phase of growth. At the time, the country was suffering the effects of the subprime mortgage crisis which would soon ignite a nationwide recession. Capital was therefore difficult to come by, and potential investment partners were few. When it looked like they had found two firms who were willing to invest, Lily was understandably thrilled, despite the feeling that one of the firms was perhaps not exactly the right fit. Given the tight economic environment, she pushed these worries aside and hoped for the best, grateful for the funding and the opportunities it would enable.

In spring 2009, Serena and Lily closed its second institutional round of $5 million in venture capital financing in return for a 16 percent interest in the company. Its first board of directors, with Serena and Lily representing two seats, was comprised of six total members. Lily had elected her board chair, Bill Stanton, early on, having identified him as the most seasoned and trusted of her board members. Bill had worked in venture capital for years, and though he had retired five years earlier, remained active on several boards and continued to make personal investments in pet projects and various startup companies. Lily had met Bill through one of her previous colleagues in the tech world, and he had immediately taken an interest in the company, signing on as an investor during the friends and family round. He had proven to be fair-minded and insightful, and always strove to weigh the opinions of the two cofounders against the board's often strong and sometimes opposing views.

Irene Redd and Malcolm Henshaw, investors from the venture capital firms that had invested in the recent round of financing, represented two additional board seats. Irene and Malcolm had started their careers at the same private equity firm and had a long professional history working together, often on the same deal. Christine Graf, an executive director from one of the nonprofits Lily had worked closely with after leaving Microsoft, held the last board seat. Graf had no prior experience working in retail but Lily had always found her to be incredibly bright and able to provide a reasoned and astute perspective on many issues.

In less than a year, Lily encountered both the benefits and challenges of having a board. One board member in particular, Malcolm Henshaw, had become a problem. His firm had historically invested only in companies in which it could hold the majority share. However, that had not been an option when investing in Serena and Lily—a stipulation about which Lily felt very strongly—but Malcolm's firm chose to invest anyway, with the understanding that it would hold a minority interest with equivalent ownership to the other venture capital firm that was also investing.

Much to Lily's dismay, Malcolm's behavior was adversarial from the very first board meeting. He consistently used an aggressive, almost bullying, tone when stating his position and often posited ideas related to strategy, marketing or pricing that were conveyed as statements of fact rather than suggestions as to how the company should move forward. In one such instance, he asserted that it was time for Serena and Lily to raise the pricing of their twin bedding and to increase shipping charges to capture more dollars from the back end. Lily knew that most web-based retailers were heading to a free shipping model, and she was also concerned about raising prices any further on a product that was already at the upper end of the market. However, she relented, largely to avoid an all-out battle over a topic on which Malcolm had so strongly expressed his opinions.

Lily not only found herself struggling with Malcolm's personality, she saw the toll it was taking on the board. Though Irene was used to his abrasive style after years working with him, Graf's reaction was often to take a step out of the fray to avoid adding her opinions to an already stressful situation. Bill, on the other hand, was not one to be pushed out of the way and as board chair, he did a good job managing the various personalities. However, Lily often felt that he had to spend more time navigating the interpersonal dynamics between board members than helping the group come to resolution about the important decisions they were facing. This was particularly frustrating to Lily given her feeling that they simply had no time to waste on posturing and egos.

The tension came to a head at the October 2010 board meeting when Lily found herself in a standoff with Malcolm over an issue on which she was not willing to budge. She had seen the negative implications of giving in (e.g. twin bedding sales dropped 20 percent soon after Malcolm's suggested price increase), and did not want to face similar consequences here. Malcolm had long argued that the company should slow its growth to focus on becoming profitable, largely to minimize its cash needs going forward. Serena and Lily, along with the three other board members, strongly disagreed, believing that now was the time for the company to invest in its growth and take advantage of the traction it had gained in the marketplace, particularly in the direct-to-consumer space. In fact, Lily believed that the company should completely dissolve the wholesale channel to focus solely on direct-to-consumer sales, a position with which Malcolm disagreed vehemently.

The covenants associated with Malcolm's firm's investor agreement with Serena and Lily dictated that a target percentage of revenues be met by sales from the wholesale channel (i.e. the retail stores who sold to individual consumers), and he relentlessly referred back to these covenants during the course of their discussion about the strategic direction of the company. In Lily's mind, Malcolm was so focused on the details that he had completely lost sight of what was best for the company and its shareholders. Though Bill had done his best to moderate, he was clearly torn between trying to be objective while needing to respect the contractual obligations set forth by the investor agreement. After arguing back and forth to no avail, Lily finally threw up her hands and asked to table the topic until both she and Malcolm could cool down.

After the board meeting, Serena and Lily went out to dinner to blow off some steam and discuss the events of the day. The tension with Malcolm had started as a small flame in 2008 and had grown to a forest fire over the last two years that threatened to completely take down the small company. Serena and Lily knew that something had to change, but they weren't sure how best to proceed. The most obvious choice, but one which neither of them wanted to face, was the option to sell the company and wash their hands of the whole situation. Alternatively, they could eliminate the source of the problem by buying out Malcolm's firm's ownership stake in the company, removing him from the board all together. While this was attractive on a number of levels, the cofounders knew this would be complicated, time-consuming, and inevitably involve significant legal fees. Finally, they discussed the option of dealing with the situation directly.

Though Lily had tried in the past to have a one-on-one discussion with Malcolm to resolve the friction between them, this latest interaction felt like a new low. She considered going to Irene for advice, but Lily was concerned that because of Irene's allegiance towards Malcolm, their conversation would not remain confidential. She also thought about talking with Bill—he had always proven to be a straight shooter, and she knew that with his years of experience, he had likely seen a situation like this before. However, she feared that his own energies around this topic might be exhausted; additionally, he might have conflicting interests that would make it difficult for him to give her objective guidance. As she considered her options, she wondered whether it made the most sense to go directly to Malcolm herself. Though it felt as if they had reached a monumental impasse, perhaps she was the only person who could right the ship.

ROBIN RICE

In the spring of 2011, Lily hired Robin Rice as an outside consultant to help develop the company's merchandising strategy. Up to that point, Serena and Lily had never established a separate merchandising function within the organization, choosing instead to trust their gut and introduce what they felt the marketplace was lacking. Robin had a long track record of holding senior management positions at a variety of high-profile, well-established brands, including The Gap, The Body Shop, and West Elm (a division of Williams-Sonoma). (See **Exhibit 2** for Robin's resume) After years in the corporate world, Rice started her own retail consulting firm in 2008, a move designed to give her the independence, flexibility and creativity to work on projects during a timeframe of her choosing. In the three years managing her own practice, she had seen a dramatic improvement in her lifestyle, work hours, and happiness, and was thoroughly enjoying the projects with which she was engaged. Robin's work for Serena and Lily was as exceptional as her background would imply, and Lily was thrilled to have someone with such strong functional expertise working as part of the team.

About six weeks after Robin started, she casually mentioned to Lily over lunch a job opportunity she was considering. Robin had been in discussion with an $8 billion, global, multi-brand organization for the last seven months, and had just been offered the position of general manager overseeing the retail portion of the company's entire portfolio of international brands. Robin explained that while her consulting practice was incredibly fulfilling, this position offered her a clear upward step in her professional career. Not only would she serve as a senior executive of a highly prestigious corporation, she was excited about the opportunity to manage a major strategic shift for such a large global suite of products. In addition to her title and responsibilities, the position came with a healthy six-figure salary and an extremely attractive stock option package.

Lily's first response upon hearing the news was panic. In Robin's very short time working at Serena and Lily, she had provided invaluable guidance and wisdom from years in the business, helping Lily make several critically important strategic decisions. Lily was not sure what she could do to compel Robin to turn down the offer, but she asked to have until the end of the day to talk with her board and Serena to come up with a plan. She promised to call Robin that evening with a proposal that would hopefully change her mind.

Lily left the lunch stunned, but resolved to take action immediately. She knew they would never be able to compete with the package or prestige offered by Robin's new position, and there was no sense even trying. In evaluating her options, Lily realized she was also competing against Robin's current situation—Robin had reiterated numerous times that while she was not making huge dollars from her own practice, the income was good and the intangible benefits were outstanding.

After consulting with Bill and Serena and considering the company's financial capabilities, Lily sat at her desk to jot down the details of the package she would present. Her offer to Robin would be a part-time position at the equivalent of $80,000 per year until October. In October, the company expected to obtain another round of financing, allowing Lily to increase Robin's salary to $200,000 for a full-time position, which would also entitle her to a full stock option package. Lily knew that compensation was among her weakest negotiation points given Robin's other offer on the table, and she would need to come up with a compelling argument as to why Robin should choose to join Serena and Lily, a relatively tiny retail startup, over continuing to build her own business or signing on for a role that perhaps could be the opportunity of a lifetime.

Just before calling Robin, however, Lily began to wonder whether she was about to commit a strategic gaffe. There was so much she did not know about Robin's existing offer, not only in terms of the financial aspects but qualitative elements as well. How much time did Robin have to make a decision, and did she really want the position? Did Lily even have a chance of winning? And finally, was a telephone call the right mode of communication?

Exhibit 1
Co-Founders Bios

Lily Kanter
Co-founder Lily Kanter brings 18 years of experience in business and technology to Serena & Lily. She has held management positions at Microsoft, Deloitte & Touche and IBM. Career highlights include creating the first Microsoft flagship store in downtown San Francisco—a move which earned her the Chairman's Award from Bill Gates. Philanthropy is a driving force for Lily, and in July 2000 she was featured on the cover of Time magazine as part of the story "The New Philanthropists." Her philanthropic projects include founding Social Venture Partners in the Bay Area and the Serena & Lily Foundation, the latter devoted to inspiring kids to change the world. She also co-founded the Sarosi-Kanter Charitable Foundation with her husband Marc. Lily attended the Executive MBA program at Pepperdine and the Pepperdine Asia Business Program in Hong Kong. She is a Wexner Fellow and a Henry Crown Fellow and holds a BA in Accounting from Arizona State University. Lily lives in Mill Valley and has three boys ages 6, 8 and 10.

Serena Dugan
Serena Dugan, co-founder of Serena & Lily, has 11 years of experience designing and painting as a freelance decorative painter, textile designer, and commissioned artist. Under her design collective "Serena Dugan Design Studio," she designed for corporate clients, interior designers and private clients nationwide, and developed her signature line of hand block-printed fabrics and accessories sold through Interior Designers and high-design boutiques in San Francisco and Los Angeles.

Serena worked for over 4 years with Pottery Barn Kids on their Creative Team, where she served as their lead on-set decorative painter and artist, as well as their Product Development Team, where she created original artwork and accessories replicated and sold in their catalogs. Additional corporate clients included Restoration Hardware and Pottery Barn. Serena was trained in Fine Art and Design at the Lorenzo de' Medici Art Institute in Florence, Italy. She holds a bachelor's degree in Psychology from Wake Forest University. Serena, her husband, and their two dogs live in Sausalito, California.

Exhibit 2
Excerpts from Robin Rice's Curriculum Vitae

jcr^3: a consultancy, LLC **August 2008 to present**
Founder
Projects include:
- Complete financial and strategic planning for an overseas retail company working to create a US-based division
- Created a product extension strategy for a UK-based spa
- Re-branded and created a communication plan for retail focused analytics company
- Tactical/strategic planning and execution of a retail store in Malibu, California

west elm (division of Williams-Sonoma, Inc.) **August 2005 to April 2008**
Executive Vice President
- Full P+L responsibility for emerging brand at WSI
- Directed merchandising, design, sourcing, planning and distribution functions for all channels of distribution (stores, catalog and e-commerce)
- Grew brand from catalog-only to 32 store chain
- Total volume: $240 million

The William Carter Company **July 2003 to July 2005**
Executive Vice President, Marketing
- Full P+L responsibility for the leading young childrenswear brand in the US
- Directed marketing, merchandising, design and licensing for Carter's brand as well as the Child of Mine brand for Wal-Mart and the Just One Year brand for Target
- Led the re-branding project for this 150 year old wholesale and retail children's brand which addressed the voice of the brand and its interaction with the consumer
- Total volume: $900 million

The Body Shop, Americas Region **Sept. 2002 to July 2003**
Senior Vice-President, Merchandising
- Full P+L responsibility for the US region of Body Shop International
- Total volume: $260 million

Gap, Inc. **March 1995 to July 2002**
General Manager, Gap Canada
- Full P+L responsibility for all Gap divisions (Adult, GapKids, babyGap, GapBody)
- Total volume: $675 million

Senior Vice-President, Global babyGap and GapKids Merchandising
Vice President, babyGap Merchandising
- Full P+L responsibility for the babyGap division
- Direct responsibility for merchandising and production
- Grew babyGap from a small division of GapKids to a standalone chain of over 200 stores (plus combined locations)
- Total volume: $580 million

Macy's Product Development **March 1993 to March 1995**
Pacific Coast Highway/Styl-land, Inc. **Nov. 1989 to October 1992**
Ocean Pacific Sunwear, Ltd. **Sept. 1986 to Nov. 1989**
RH Macy Corporate Buying **May 1984 to Sept. 1986**