



H.S. Grace & Company, Inc.

## Defining the Difference # 64 – February 2013

### LITIGATION TRUSTEE CLAIMS AGAINST DIRECTORS AND OFFICERS IN BANKRUPTCY PROCEEDINGS –EXAMINING THE EXTERNAL ENVIRONMENT

Understanding both the business context in which decisions are made and the external economic and business environment can be essential in breach of fiduciary duty, securities, fraud and other legal actions where good business decisions may have had bad outcomes to counter the effect of hindsight bias. Daniel Kahneman, who won the Nobel prize for his work in behavioral economics in 2002, in *Thinking, Fast and Slow* (2011) emphasized the overwhelming effect of hindsight bias when judging the actions of decision-makers such as senior executives, as follows (pp.203-204):

Hindsight bias has pernicious effects on the evaluations of decision makers. It leads observers to assess the quality of a decision not by whether the process was sound but by whether its outcome was good or bad... **This outcome bias makes it almost impossible to evaluate a decision properly – in terms of the beliefs that were reasonable when the decision was made. ...** When the outcomes are bad, the clients often blame their agents for not seeing the handwriting on the wall-forgetting that it was written in invisible ink that became legible only afterward. Actions that seemed prudent in foresight can look irresponsibly negligent in hindsight.

The following H.S. Grace & Company, Inc. (HSG) expert witness assignment involving claims against the executive management and certain directors of a twice bankrupt company demonstrates the importance of understanding both the external business environment and the business context *at the time of the decision* in evaluating actions of officers and directors.

#### Allegations

Plaintiff Litigation Trustee as the representative of a bankrupt company sued the executive officers and certain directors of the bankrupt financial services company (HSG clients) asserting that they had taken actions which breached their fiduciary duties and resulted in the second bankruptcy. Plaintiff's allegations included claims that the defendants had recklessly entered into speculative interest rate swaps for short-term benefit "knowing" that they would ultimately result in a loss over the term of the swap and that they had improperly pursued and invested in a computer software business, which had substantial cost overruns.

#### Analysis

HSG examined both the internal and external business environment in considering the claims made by Plaintiff. HSG's analysis demonstrated:

- The interest rate swap derivatives program was not a speculative program, but a prudent investment aimed at converting uncertain floating rate interest income to fixed rate, ascertainable income.
- Interest rate forecasts in bankruptcy documents in the first bankruptcy, which had been reviewed and basically concurred in by creditors, including sophisticated banking institutions, were reasonable based on the business environment at the time.
- The bankruptcy was caused by factors outside of the control of the company, including a deliberate driving down of interest rates by the Federal Reserve in response to a recession after the company emerged from bankruptcy the first time.
- The approximate 10% cost overrun in the development of the software product was not unusual at the time in developing new and complex software programs in the financial services industry.
- Management made appropriate disclosures to the board and to the public as to the financial position of the company, including a disclosure that a downward trend in interest rates would negatively impact the financial results of the company.

## **Results**

The facts were presented at mediation, and a favorable settlement was reached.

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*H.S. Grace & Company, Inc. is a team of senior executives who diagnose and resolve critical corporate problems in business governance, operations, finance and control. With more than 1,000 years of experience, our goal is to help companies enhance shareholder value, protect reputation and their long-term ability to succeed, avoid and manage litigation, and navigate major changes such as mergers and acquisitions or bankruptcies. We often serve as consulting and testifying experts, identifying and analyzing critical business issues.*

## **Representative Issues Examined**

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|--|-------------------------------|
| • Lender Liability                             | • SEC White Collar Defense    |
| • D&O  | • Stock Option Backdating     |
| • Corporate Split-off                          | • Oil & Gas                   |
| • Family Trust                                 | • Real Estate                 |
| • Health Care                                  | • Fiduciary Issues            |
| • Professional Services                        | • Contract Dispute            |
| • Intellectual Property                        | • Fund Management             |
| • International Structured Finance Transaction | • Market Timing Allegations   |
| • Fraud  | • Financial Derivatives       |
| • Pension Fund Investments                     | • Portfolio Management        |
|  | • Special Purpose Corporation |

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