H.S. Grace & Company, Inc.

Defining the Difference # 66 – May 2013

PRIVATE EQUITY LITIGATION: FIDUCIARY DUTIES

Breach of fiduciary duty and aiding and abetting claims against directors and officers and affiliated entities are common in litigation involving private equity acquisitions of distressed assets, particularly claims by liquidating trustees in failed ventures. The experience of H.S. Grace & Company's (HSG) team of active and former senior executives and board members enables us to evaluate these claims and the complex business and financial structures and relationships in each individual case and address both liability and causation issues. We have set out below a summary of a representative case involving both breach of fiduciary duty claims and aiding and abetting claims.

Allegations

Plaintiff, the liquidating trustee of a bankrupt retail company sued the former directors and officers (D&Os) of the bankrupt entity and the bankrupt entity's corporate parent and related companies (HSG clients) for breach of fiduciary duty and for aiding and abetting the alleged fiduciary duty breaches – both the duty of care and the duty of loyalty. The Trustee challenged the propriety of numerous transactions over the entity's five year history, contending that the entity was insolvent from the start. Specifically, the Trustee asserted: (1) the acquisition structure and financing using bridge financing by the private equity fund was inappropriate; (2) the restructuring of the entity shortly after acquisition, by replacing the bridge financing with a permanent revolver and using a portion of asset sale proceeds to pay off a portion of the bridge loan was improper; and (3) the spin-off of the retail company from its corporate parent was not effected properly. Plaintiff also asserted, as is common in these types of cases, that the D&Os had various conflicts of interest due to the overlapping boards of the entities and that the D&Os had failed to observe corporate formalities and inappropriately used uniform written consents to approve various transactions rather than holding board meetings.

HSG Analysis

The HSG team evaluated the complex structural and financing relationships among the defendant entities and the actions of the D&Os, using their extensive experience in similar situations and in complex financing arrangements and applying customary and normal business practices to assess the transactions and the D&O actions. A summary of some of HSG's conclusions is set out below:

- The use of interim, short-term financing provided by the acquirer to be replaced by permanent, third-party financing within a few months of closing is a common and well-recognized business practice in acquisitions like this.
- The private equity fund contributed a substantial amount of its own capital to the deal and the D&Os had equity in the deal, which acted as a strong incentive to work toward the success of the entity.
- The permanent financing provided revolver liquidity to the acquired entity, an important financial benefit to the retail entity; the entity providing the permanent financing required the payoff of the interim, short-term financing as a condition of the permanent financing.
- The asset sales and outsourcing of functions of the retail entity after the closing were part of a long-term plan commenced by the prior owner based on the advice of well-recognized experts. The plans were

thoroughly analyzed and vetted by both the D&Os and outside experts working on their behalf both before and after the acquisition.

- The asset sales and other restructuring actions were expected to result in significant cost savings and improved operational efficiencies, profitability and cash flow for the entity post-closing. The transactions had a valid business purpose and were reasonably implemented.
- Separation of assets is common and generally required in spin-offs. In this case, the spin-off was thoroughly vetted, and assignment of assets was appropriately made consistent with the obligations of the parties. Further, the spin-off enhanced opportunities for sale of the entity if a decision were subsequently made to pursue that route.
- It is common in private company parent-subsidiary and affiliate situations like this for companies to have overlapping D&Os. In this case, the D&Os implemented a reasonable process to address the situation by assigning different entity perspectives for individual directors to assess transactions and by thoroughly analyzing and debating the various decisions.
- External economic and market conditions contributed significantly to the failure of the entity.

Results

The case was settled for a favorable amount.

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

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

Houston: 4615 Southwest Freeway, Suite 625, Houston, TX 77027
(713) 572-6800 • FAX (713) 572-6806

New York: 300 E. 57th Street, #18A, New York, NY 10022
(212) 644-8620 • FAX (212) 813-1779

Email: hsgraceco@hsgraceco.com
Visit us at: http://www.hsgraceco.com