



H.S. Grace & Company, Inc.

Breach of Fiduciary Duty Claim Against Directors and Officers of Bankrupt Corporation Alter Ego, Single Business Enterprise and Agency Theories to Extend Liability to Large Investor in Bankrupt Corporation

Business failures are at the heart of many lawsuits against directors and officers. Hindsight is 20-20. But all business decisions involve risk, and decisions made by the board and others must be considered in the context of the business climate and practices existing at the time the decision was made. Determining why a business failed can be a complex task requiring the unraveling of complex business structures and relationships and examination of both the external and internal business environment to understand the underlying causes for the failure. H.S. Grace & Company, Inc.'s (HSG) team of senior management level executives and board members have extensive experience with complex financing arrangements, structuring asset sales, funding arrangements for corporations, partnerships and joint ventures and oversight and management of business enterprises. The following assignment demonstrates how that experience in examining and assessing complex business decisions can prove useful in resolving litigation involving business failures or missteps.

Allegations

Plaintiff trustee of the creditor trust of a bankrupt estate sued defendant directors and officers of a bankrupt retail broker alleging that they had breached their fiduciary duties by failing to protect the value of the broker's assets and by failing to act in the best interests of the broker both before and after the bankruptcy filing. Plaintiff asserted that the directors and officers of the retail broker were conflicted because they also acted as directors, officers and contract managers of an investment vehicle owned by a larger enterprise, which had invested indirectly in the publicly held retail broker. Plaintiff contended that the larger enterprise was liable for the brokerage business's failure because the entities were conducted as a single business enterprise. Plaintiff further argued that the activities of the broker were conducted by the defendant directors and officers in furtherance of the interests of the larger enterprise rather than the broker. Plaintiff's legal causes of action included claims for breach of fiduciary duty, corporate waste, conspiracy and fraud. Plaintiff asserted various agency, alter ego and single business enterprise theories in an attempt to reach the deep pockets of the larger enterprise. The larger enterprise retained HSG to examine 1) the investment structure, strategies and vehicles set up to make the investment in the retail broker; 2) the business model utilized by the broker; and 3) the circumstances leading to the bankruptcy of the retail broker.

Analysis

Using their extensive experience in complex financial structuring arrangements and in oversight and management of interrelated business enterprises, the HSG team determined based on the specific facts at issue:

It is customary and prudent for successful businesses and their owners to seek to expand and diversify their holdings by investing in new areas of business activity.

The investment structure utilized incorporated well-thought out organizational structures that clearly separated the investment and the investors.

It is customary for individuals in merchant banking firms to assume an active role in the oversight and even the management of the operations; this structure offers both competent advice and economies of scale to the entities in which they invest.

The business model used by the bankrupt entity – growth by acquisition – was based on industry conditions, practices and trends and consistent with customary business practices.

Mergers and acquisitions characteristically involve system and cultural integration issues. The issues encountered in this case were typical, but exacerbated by unexpected changes in external economic conditions, including the virtual drying up of external sources of financing, and increased competition in the industry, as well as other factors.

The directors and officers of the retail broker, who had considerable financial expertise, attempted to address their responsibilities relative to preserving the broker's value, in the face of changing external conditions, consistent with customary and ordinary business practices, including seeking opportunities to reorganize and restructure debt, selling assets, and exploring opportunities for external financing.

Undertakings such as the effort to grow the broker into a nationally recognized operation through acquisition always face the potential of failure as they work through their years of initial development. It is not only expected, but projected, that they may experience losses in the early years, and the question is always an open one as to whether ultimately financial success will be achieved.

Result

A satisfactory settlement was reached after extensive discovery.

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.

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