



H.S. Grace & Company, Inc.

Analysis of Risk Disclosures and Due Diligence in Claims Under Section 11 of the Securities Act of 1933

Disclosure of risk factors facing businesses in Registration Statements and Prospectuses is a key issue for officers and directors in litigation involving claims under Section 11 of the Securities Act of 1933. Examining the diligence of the officers and directors in addressing their roles and responsibilities both before and after the offering and the extent of their reliance on outside advisors is necessary to evaluate these claims. Understanding the external economic and business environment, particularly in the industry at issue, also frequently plays an important role in these cases. H.S. Grace & Company, Inc.'s (HSG) team of senior management level executives and board members is often asked to evaluate these and other issues in securities actions, using their actual, real-life experience in the establishment, financing and operation of a broad range of businesses. Following is an analysis of a recent claim under Section 11 of the Securities Act of 1933 in which HSG was engaged to examine the due diligence and investigation of the directors and officers prior to an IPO.

Allegations

Plaintiff shareholders filed a class action against Company X and its officers and directors (HSG client), and against the underwriter asserting that defendants had failed to disclose and misrepresented certain material risks in a Registration Statement and Prospectus relating to the Company's IPO. Specifically, plaintiffs alleged that Company X and its officers and directors failed to include in the offering documents the "fact" that its reported profits and revenues had been distorted by gray marketing and that its future profits and revenues were threatened by the gray market distribution of its products. Plaintiffs contended that when the truth became known Company X's stock price dropped precipitously as a result of the misrepresentations and omissions.

Analysis

Drawing on their extensive experience in the investment in, financing and operation of complex business organizations, the HSG team evaluated plaintiffs' allegations and concluded that defendant officers and directors had conducted a thorough and proper investigation consistent with normal and customary business practices, prior to the IPO, and properly relied on the advice of experts they had engaged in connection with the offering. Specifically, HSG concluded:

- The disclosures in the Registration Statement and Prospectus appropriately described the risk factors facing the new company.
- The insignificant and highly localized gray marketing issues facing the company prior to the IPO were a normal part of business in the industry.
- The directors and officers conducted a thorough investigation prior to the IPO and relied on the advice of experts, along with the results of their investigation, in disclosing material risk factors facing the business.
- The directors and officers appropriately used their business judgment in determining the risk factors disclosed in the Registration Statement and Prospectus.

- A general decline in demand in the industry after the IPO affected revenues and profits across the industry.
- IPO's and particularly, IPO's involving new products, involve risk.
- Competition and market saturation, along with the general decline in industry demand, affected defendant's sales after the IPO, eventually resulting in a decline in defendant's stock price when it failed to meet analyst expectations.

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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