

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

Michael Tate, Joseph Shuster, Lyle
Evanson and Jack Ayers, individually
and on behalf of all other individuals
similarly situated,

Civil No. 09-cv-02076 MJD/JJG

Plaintiffs,

**MEMORANDUM OF LAW
IN OPPOSITION TO
PLAINTIFFS' MOTION FOR
PUNITIVE DAMAGES**

v.

Restaurant Technologies, Inc.,
Parthenon Capital LLC, Jeffery R.
Kiesel, John C. Rutherford, Jonathan
O. Grad, Zachary F. Sadek, Phillip A.
Clough and Robert E. Weil,

FILED UNDER SEAL

Defendants.

INTRODUCTION

Plaintiffs would have the Court believe the money they invested ten years ago was pillaged by ravenous venture capitalists who wrongfully appropriated a valuable company for their exclusive benefit. Nothing could be farther from the truth.

The true story of Restaurant Technologies, Inc. ("RTI") is far less dramatic and far more common: a start-up company with a new idea reasonably sets out on a course of substantial growth—a course, as described below, that was charted by the very Plaintiffs now claiming to have been harmed—only to find that raising capital and incurring enormous debt has left it with limited alternatives for survival in a changed economic world and, unfortunately, with no value for those shareholders, like Plaintiffs, who were unwilling to continue investing when the company needed more capital. Indeed, during

the ten years of its existence RTI suffered cumulative losses of over \$143 million. As a result, RTI repeatedly ran through all of its capital and had to attract new equity to survive. When it was unable to fund operations from its original shareholders, RTI hired an investment banking firm who contacted a number of venture capital firms seeking to convince them to provide the funds it needed. Ultimately that process resulted in RTI's Board (which included two Plaintiffs, but no Defendant or representative of any Defendant) negotiating a series of agreements with Parthenon pursuant to which Parthenon made its initial investment—\$16 million of the \$47.2 million it ultimately invested in RTI—to provide RTI with badly needed capital. These agreements provided Parthenon with certain rights that were standard for an investment in a risky start-up like RTI. In addition, RTI repeatedly gave Plaintiffs and other common shareholders the opportunity to invest additional funds on the same economic terms as Parthenon, but Plaintiffs generally chose not to do so even though their ownership percentage obviously declined as a result.

Despite Plaintiffs' narrative to the contrary, the story of RTI is not one of greed and self-dealing but of Defendants' repeated funding of RTI's capital needs, good faith exercise of business judgment, and best efforts in challenging circumstances to create value for all shareholders. That the result of those good faith efforts has been constrained by economic realities is unfortunate, but it is not evidence of wrongdoing and certainly not the stuff of punitive damages.

Plaintiffs' exhibition of snippets of conversation and portions of documents, all taken out of context, then twisted and decorated with adjectives and adverbs, cannot alter

the essential truth. Whatever disappointments they have, however much they disagree with company decisions over the ten years, no matter how strong their belief they could have managed the company better, Plaintiffs were not the victims of any scheme.

Defendants did not take anything from them. Simply put, RTI never was, never became, and is not now as valuable as Plaintiffs hoped. Neither its performance nor the markets ever supported an IPO or sale at a high price. RTI has never been a gold mine for the venture capital investors who risked their capital and for their efforts now must defend themselves against accusations of self-dealing and deceit. Indeed, Parthenon's \$47.2 million investment over nine years was valued, as part of the recapitalization transaction Plaintiffs challenge, at only \$19.8 million. The essential truth is that all investors lost money—a lot of money—and none more than Parthenon.

Defendants will disprove Plaintiffs' claims on the merits at the appropriate time and in the appropriate motion. It is enough for now that Plaintiffs have not met their heavy burden to justify a claim for punitive damages. For one thing, they ignore the fact that the state law governing Defendants' conduct (that of Delaware for fiduciary duty claims and Massachusetts for common law claims) does not allow for punitive damages in a dispute such as this. For another, the actual evidence in the case, as opposed to the dark rhetoric in Plaintiffs' brief, shows that Defendants' conduct was not marked by deliberate disregard for the rights of others. In the absence of prima facie evidence of such deliberate wrongdoing, there can be no claim for punitive damages.

Plaintiffs have over-reached in an apparent attempt to gain strategic leverage. The Court should deny their motion to add a claim for punitive damages and leave the parties instead to focus on the merit—or lack thereof—of Plaintiffs’ claims.

STATEMENT OF FACTS

Plaintiffs’ motion is based on an unfounded conspiracy theory, an approach Plaintiffs are able to support only by reference to a patchwork of isolated, purportedly sinister statements they have taken out of context and twisted beyond their meanings.¹

As the Delaware Chancery Court has observed, however:

All corporate combinations leave in their wake certain artifacts—documents, e-mails, conversations, and notes. If one digs through enough of the rubble of a consummated merger, one will almost invariably find something questionable. A clever corporate archeologist can extrapolate from these suspicious artifacts and concoct a theory of malfeasance, disloyalty, and bad faith. Yet, theories alone cannot lead to liability.

In re Transkaroytic Therapies, Inc., 954 A.2d 346, 349 (Del. Ch. 2009). A fair assessment of whether punitive damages, an extraordinary penalty, is warranted requires context and far more of the truth than Plaintiffs have provided the Court.

The necessary context is set forth below.² It will make ineluctably clear that punitive damages are not warranted in this case.

¹ Plaintiffs seek punitive damages only against (1) Parthenon, a venture capital firm and RTI’s largest shareholder; (2) Mr. Grad, a managing partner of Parthenon and Parthenon’s designee on RTI’s board since 2006; (3) Mr. Sadek, an employee of Parthenon and Parthenon’s designee on RTI’s board since 2008; and (4) Mr. Kiesel, RTI’s CEO since July 2005.

² Because Plaintiffs chose to bring this motion well before the completion of discovery, Defendants have not yet had the opportunity to give their depositions. This Statement of Facts is based on the record elicited thus far—a record that belies the calculated misreading Plaintiffs attempt to impose.

I. RTI WAS A CAPITAL-INTENSIVE START-UP.

RTI is in the business of supplying bulk cooking oil management services to the foodservice industry through proprietary technology and a services-based solution to storing, using, and disposing of cooking oils. (Dkt. #11, Ex. 1 at 53.)³ RTI enters into exclusive long-term contracts with customers to install its system and periodically refill the new oil reservoir and remove waste oil through a specially designed delivery truck. (*Id.* at 53-54.) RTI generates revenues from selling cooking oil, servicing the equipment, and selling waste oil (“yellow grease”). (*Id.* at 54.) In 1999, when it became a stand-alone company, RTI was servicing approximately 275 independent restaurants. By 2009 it had grown into a national company servicing approximately 14,000 restaurants, including nearly 8,000 McDonald’s outlets, through 36 depots covering 42 of the country’s 50 largest metropolitan areas. (*Id.* at 53, 55.)

RTI’s business model requires it to purchase and install its proprietary system at each outlet, establish oil depots and purchase and operate a fleet of delivery vehicles. This requires extensive up-front working capital. Initially, RTI met its capital needs by selling common shares. Its founders marketed those shares to their families and friends and ultimately were able to raise approximately \$10 million. (Declaration of Michelle S. Grant (“Grant Decl.”) Ex. 1 at 25-28; Ex. 4 at 4.)

To fuel its growth the company became a voracious consumer of capital. In 2001, when the \$10 million raised through several offerings of common stock had been

³ Dkt. #11 contains the Proxy Statement Offering Memorandum dated May 13, 2009.

exhausted, the company considered all potential sources of financing, including additional equity and debt.

II. RTI RAISED CAPITAL BY ISSUING PREFERRED SHARES.

After extensive consideration and consultation with financial experts, RTI's board decided that the best alternative for obtaining the capital necessary to pursue the growth strategy they believed, in the exercise of their business judgment, to be best for the company and its shareholders was through the issuance of preferred shares. An investment banking firm retained by RTI, William Blair & Company ("Blair"), then interested Parthenon in the offering.

Among those who approved the preferred shares offering were named Plaintiffs Tate, who served on the board, and Shuster, who as a large shareholder was asked to expressly approve it. (Grant Decl. Exs. 5 & 6.) The decision they made turned out to dictate the company's future course of leveraged growth and a concomitant capital structure—the very course Plaintiffs now contend to be an evil scheme perpetrated on them by Parthenon and its agents.

On terms that even Plaintiffs concede to be typical for venture capital financing of risky start-up companies, Parthenon invested approximately \$16 million in Series A-1 preferred shares. (Grant Decl. Ex. 1 at 34-35; Ex. 2 at 48; Ex. 3 at 22, 39.) Among other things, RTI's board and major shareholders agreed to give Parthenon a liquidation preference together with an accretion rate on the preferred shares that, when the company was sold (an event everyone hoped would occur within just a few years (Grant Decl. Ex. 1 at 34; Ex. 4 at 5-6)), would cause the rate of return on the A-1 shares to have grown at a

compounded rate of 20% per year. (Grant Decl. Ex. 7 at Art. IV, § 3(d)(ii).)⁴ The board and the major shareholders also agreed to give Parthenon the right to designate three members of RTI's then seven-member board and, if RTI ever failed to meet certain financial projections, the right to assume majority control of the board. (Grant Decl. Ex. 8 at § 1.2.)⁵

As was also typical of such financings, the preferred shareholders were given the right to restrict the issuance of additional securities, financings, mergers, acquisitions, sales or other dispositions of assets so that such transactions could occur only with their consent. (Grant Decl. Ex. 9 at Art. VI.) The governing documents, the Securities Purchase Agreement and the Stockholders Agreement, also provided—once again, as is typical for such transactions—that the future exercise by Parthenon of any of its rights under the agreements would not constitute a lack of good faith, a breach of fiduciary duties or unfair dealing. (Grant Decl. Ex. 8 at § 6.3; Ex. 9 at § 9.8.)⁶ Finally, the board and the major shareholders agreed to give Parthenon the right to purchase an additional round of preferred shares (“warrants”) with the same liquidation preference and accretion rate. (Grant Decl. Ex. 5.)

⁴ In the event of an IPO as opposed to a sale, the preferred stock would be converted to common stock, but only if the gross proceeds from the IPO were at least \$35 million and the price per share was at least \$64 per share, which would have been two times the highest initial value of the preferred shares. In any event, the issuance of new shares in connection with an IPO would have required the consent of the preferred shareholders. (*Id.* at § 3(e)(viii) and (ix).)

⁶ All putative class members who hold Series A stock, including Evanson, are parties to the Stockholders Agreement.

At the time of Parthenon's initial investment, shares of the Series A-1 also were offered to all existing shareholders as well as to new potential shareholders; some common shareholders, as well as several new investors including Mr. Evanson, bought these shares. (Grant Decl. Exs. 9-10.) Parthenon's large investment gave it a 43.1% ownership stake in the company. Those common shareholders, including Plaintiffs Tate, Shuster and Ayers, who chose not to participate had their equity ownership diluted.

In late 2002, when the company needed additional financing, Parthenon exercised the warrants and invested another \$5 million (the Series A-2 round). Both Tate and Shuster expressly approved of the Series A-2 round. (Grant Decl. Ex. 11-13.) Parthenon also waived its right to assume majority control of the board when the company failed to meet its projections in late 2002. (Grant Decl. Ex. 14 at 56.) In connection with the exercise of warrants, all existing shareholders were offered the opportunity to purchase common stock at the same price. (*Id.*) Parthenon itself purchased \$2 million in common stock and became one of the largest shareholders of common stock. (*Id.*) Its ownership stake grew to 49.7%.

RTI used the proceeds from the Series A-1 and A-2 issuances to finance its rapid growth. It acquired equipment and delivery vehicles, it hired a sales force, it built depots in several parts of the country, and it paid the costs of buying and installing its system in restaurants. The company focused on developing a relationship with McDonald's and with a variety of local, independent restaurants. Although by the end of 2002 Mr. Tate and Mr. Shuster had ceased any formal role with the company, both of them continued to stay in close contact with company officers and board members. (Grant Decl. Ex. 1 at

67-68; Ex. 2 at 72-76.) In that context, they regularly offered opinions and received information regarding the company's plans and prospects. (*Id.*)

At the time it sought capital from Parthenon in 2001 and from that time onward, RTI attempted to project how much it would grow and how profitable it would become. Management, however, consistently offered projections that turned out to be too rosy. Indeed, results often fell woefully short of management's projections. For example, in the offering memorandum that RTI provided to Parthenon and other investors in 2001, the company projected it would achieve net income (that is, profitability) by 2004. (Grant Decl. Ex. 4 at 7.) Six years later, the company still has yet to achieve net income for any year and has accumulated losses of \$143 million through 2009. (Grant Decl. Ex. 15 at 16.) Similarly, the company projected 25,000 customers by the end of 2006. (Grant Dec. Ex. 4 at 2.) Even today the company only has 14,000 customers, well below those early projections. (Dkt. #11, Ex. 1 at 55.)

Plaintiffs concede the issuance of the Series A-1 and A-2 preferred shares was in the company's best interests. (*See* Am. Compl. ¶ 30.) What they choose not to acknowledge, however, is that the terms on which those shares were sold, terms which became contractual rights evidenced in the company's certificate of incorporation, meant that for the common shares to continue to have value the company needed to grow its revenue—and its profitability—so that there would be money left after the preferred shares, the value of which was growing every year with the accretion right, were paid out upon a sale. The longer it took for that to happen, the more the value of the preferred

shares would grow and the more the size of the acquisition price would have to grow for the common shares to have any value.

III. RTI'S GROWTH STRATEGY DICTATED A NEED FOR MORE WORKING CAPITAL THROUGH LOANS AND ADDITIONAL PREFERRED OFFERINGS.

To build out its business (including the many oil depots a national presence required), RTI required substantially more capital than the initial equity offerings could provide. The company accordingly pursued, on a basis its then CFO John Ruelle described as nearly continuous, debt financing from various sources. (Grant Ex. 3 at 66, 66-68; Ex.16 at 5.) RTI financed its vehicles through manufacturers and much of its equipment through sellers. (Grant Dec. Ex. 3 at 66-67.) Working capital came from loans, for which RTI had to pledge its receivables and other assets. (*Id.*) In every case, RTI's continuing inability to meet its financial projections adversely affected its ability to obtain capital, decreasing the amount readily available and increasing the cost of what it could obtain.

In late 2003, RTI's board (on which Parthenon still had only three of seven seats) decided, after again receiving advice from Blair, to issue another round of preferred shares (Series A-3). (Grant Decl. Ex. 16.) The board considered this the best means available in the circumstances to raise the additional capital the company's growth required. (Grant Decl. Ex. 3 at 61.) The company determined that if it were to slow its growth rate it could achieve net income profitability and become cash flow positive sooner, but believed the long term business opportunity supported an accelerated rollout plan. (Grant Decl. Ex. 16 at 3-4.) Because Parthenon did not wish to increase its stake in

the company and in an effort to get the most attractive price possible, Blair presented the offering to several venture capital firms. (Grant Decl. Ex. 17.) ABS Capital presented the best offer and invested \$13 million; Parthenon invested an additional \$9.9 million. (Grant Decl. Ex. 18 at 37-38.) Parthenon's ownership fell to 46.5%.

In exchange for their investments in the A-3 shares, Parthenon and ABS each received the right to designate a board member (giving Parthenon the right then to designate four of the board's seven members) and to received the same liquidation and accretion rate that the earlier preferred shares carried. (Grant Decl. Ex. 19 at § 1.2; Ex. 7 at Art. IV, § 3(d)(ii).)⁷ Although under the Stockholders Agreement Parthenon could declare any offering to be exempt, and not offer it to other shareholders, (Grant Decl. Ex. 19 at § 2.5), it agreed that the same financial terms be offered to all shareholders as well as to new potential shareholders; a very few common shareholders purchased A-3 shares. (Grant Decl. Ex. 18 at 38-39.) Those common shareholders who chose not to participate in the offering, including Plaintiffs, had their equity ownership diluted proportionately.

IV. RTI'S PURSUIT OF CONTINUED GROWTH: THE ONLY MEANS FOR SUCCESS.

Plaintiffs concede that the issuance of the Series A-3 shares also was in the company's best interests. (*See* Am. Compl. ¶ 30.) They avoid discussing, however, the

⁷ The additional board seat obtained by Parthenon went to Mr. Grunewald, who was a large common shareholder and had been on the board since 2000 as a designee of the common shareholders. (Grant Decl. Ex. 19 at § 1.2.) Prior to his appointment to fill a Parthenon-designated board seat, Mr. Grunewald was not affiliated with Parthenon in any way and Parthenon only came to know him as a result of his membership on the board of directors at the time of Parthenon's initial investment. Parthenon's only relationship with Mr. Grunewald has been as a director of RTI.

