Published on *The National Law Review* https://natlawreview.com

Business Litigation and Fiduciary Duties - What Partners Should Know about Settlement Agreements

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Business partnerships, like marriages, do not always work out. Business partners often disagree about issues like control, expansion of the business, raising additional capital, compensation and succession planning. Unlike a marriage, in which the couple must go to court to secure a judgment dissolving the marriage, business partners often agree between themselves as to how to resolve their differences before litigation concludes. Unlike most marital assets, which usually are divided, it is usually imprudent to dissolve a business and distribute its assets because a business is typically worth more to both partners as an ongoing business. Thus, these disputes are often settled by one partner "buying out" the other's interest in the business. These buyouts have spawned even more litigation between the former business partners because the rights and duties of the partners in negotiating these buyouts are not sufficiently clear.

To provide clarity, courts can and should hold that parties may not rely upon the existence of any presumed fiduciary duties once parties are engaged in litigation. Specifically, parties should be barred from claiming that they relied upon their adversaries' alleged fiduciary duties of "full and frank" disclosure to extricate themselves from negotiated settlement agreements. Such a rule would put these parties on the same level as all other litigants and parties negotiating a transaction, *i.e.,* they would be required to negotiate specific representations and warranties regarding the factual assumptions each of the parties is relying upon in entering into the settlement agreement. Such a standard would provide more certainty to parties, making settlement more attractive. The perils of the current state of the law are apparent in a recent, but not atypical case in Illinois.

Lew Borsellino, Jerry Putnam and MarGwenn and Stuart Townsend together founded Chicago Trading and Arbitrage (CTA) to operate an electronic trading room for day traders in Chicago. Putnam was a broker, the Townsends were software developers, and Borsellino was a floor trader. Like many new businesses, it did not succeed. Also, like a lot of new businesses, the owners did not get along with each other. At some point, Putnam and the Townsends began to explore a new business—an electronic communication network (ECN), which they named Archipelago. Borsellino was not included in Archipelago, so he sued, claiming that Putnam and the Townsends had used CTA's resources to create Archipelago in violation of their fiduciary duties owed to the company.[1] Shortly after the suit was filed, the parties entered into a settlement agreement whereby Putnam and the Townsends bought out Borsellino's share of CTA for $250,000 and the release of all claims.[2] After Archipelago began to achieve success and secured substantial funding from Goldman Sachs, Borsellino sued again, claiming that his partners concealed material information about the company's value during settlement negotiations.[3]

After years of motion practice, discovery and appeals, the case went to trial. By that time, Archipelago had merged with the New York Stock Exchange and Putnam had become chairman of the combined entity. The jury, which had been instructed that Putnam and the Townsends had the burden of establishing that they had provided Borsellino "full and frank" disclosure of "all material information which they knew" during the settlement meeting,[4] awarded Borsellino $11 million. The Illinois appellate court overturned the jury's verdict, finding that Borsellino's claims had been barred by the terms of the 1998 settlement agreement.[5] The appellate court never reached the issue of whether the jury was properly instructed on the duties Putnam and the Townsends owed Borsellino. Thus, the question remains whether business partners, who are settling litigation with their partners, owe a fiduciary duty of "full and frank disclosure" and whether a partner who has sued his partners is entitled to rely upon such disclosure duty when settling the claims.

Unfortunately, the *Borsellino* case is not unique—secondary litigation often arises out of settlement agreements. While cases of actual fraud can and should be the subject of claims, the current uncertainty regarding the duties owed by and between settling parties provides too much opportunity to file baseless suits as a means to renegotiate the original deal. This problem is manifest in settlements between partners whereby one partner or partners buys out the other(s).

As demonstrated by *Borsellino*, it is unclear what duties putative fiduciaries owe one another when settling disputes between them. Some courts have broadly declared that "[p]arties in a fiduciary relationship owe one another a duty of full disclosure of material facts when making a settlement and obtaining a release."[6] Courts applying this rule have also found, for instance, that "a severance agreement arising out of a fiduciary relationship is voidable if one party withheld facts that were material to the agreement."[7] Unfortunately, the application of this broad standard has created opportunities for litigants to undo settlement agreements, or at the very least, institute further or renewed litigation as to whether there a "full and frank" disclosure of all material facts known by adversaries took place at the time of settlement. Under the current state of the law, a disappointed party has two paths to undoing the settlement: 1) claiming that his counterparty made a misrepresentation, or 2) arguing that his counterparty failed to disclose an alleged material fact. In either case, the claim will likely survive summary judgment and the case will proceed to trial—exactly what the parties intended to avoid by settling in the first place.

To provide finality to settlement agreements among former business partners, and to prevent years of potential lawsuits by disgruntled litigants, courts should consider adopting a rule that litigating business partners cannot rely upon the existence of any presumed fiduciary duties between them. Such a rule would not only acknowledge the realities of litigation between business partners, but it would additionally uphold the current law on fiduciary duties in the context of litigation. There are two possible bright-line rules that courts could apply: first, a rule that holds that the fiduciary duty ceases at the start of litigation; or, second, a rule that holds that the fiduciary duty does not apply during settlement negotiations. Although the particulars of the rules differ, both rules would help provide finality to settlement agreements between former business partners and prevent frivolous litigation years after the agreements are signed.

The first bright-line rule that courts could apply is that, as soon as business partners commence litigation as adverse parties, any fiduciary duty between them ceases. Thus, in any subsequent settlement negotiations, parties would not be required to share information about all aspects of the business (such as the valuation of certain assets) that may be important components of a settlement agreement. Such a bright-line rule may seem like a substantial weakening of the fiduciary relationship, but more accurately it is an acknowledgement of the reality of the adversarial relationship between litigants. The theoretical underpinning for a fiduciary relationship is one of trust between business partners: as one court has put it, a fiduciary duty "exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence."[8] However, by the time litigation has begun, any relationship of trust between two partners has, by definition, broken down. Indeed, it is a perplexing rule that places continuing fiduciary duties on business partners in the course of litigation when, as one commentator has observed, "litigation may virtually insure that the torn relationship among partners will never be mended."[9]

In several jurisdictions, courts have already recognized the significance of litigation between partners as altering the nature of the fiduciary duty. In *Texas Standard Oil & Gas, L.P. v. Frankel Offshore Energy, Inc.*,[10] the Texas Court of Appeals considered the validity of a settlement agreement between Frankel, Inc. and three energy companies: Texas Standard Oil & Gas, L.P., Grimes Energy Co., and PetroVal, Inc. (collectively "GTP").[11] Frankel and GTP formed a limited liability company called FGP to hold licenses for developing oil and gas prospects.[12] Eventually the business relationship between Frankel and GTP deteriorated, and the parties signed a settlement terminating the parties' relationship as to FGP except for continuing to hold existing licenses, and dividing FGP's interests and assets between Frankel and GTP.[13] The settlement agreement also contained mutual release provisions from various claims, including fraud in the inducement of the settlement agreement.[14] Soon after signing the settlement agreement, Frankel sued GTP, seeking damages and rescission of the settlement agreement and claiming that GTP fraudulently induced Frankel to sign the agreement and breached fiduciary duties to Frankel by (among other things) misrepresenting GTP's ownership of certain interests.[15] The trial court rescinded the settlement agreement, and GTP appealed.[16]

The Texas Court of Appeals overturned the trial court and upheld the settlement agreement.[17] In analyzing the validity of the release, the court said that "the fact the parties were adverse litigants when they executed the Settlement Agreement also supports enforcement of the fraudulent-inducement release. This posture . . . indicates Frankel understood that GTP was protecting its own interests by negotiating inclusion of a fraudulent-inducement release, Frankel could not reasonably rely on GTP to protect Frankel's interests relative to this provision, and Frankel needed to evaluate for itself whether the provision was in its best interest."[18] The court also noted that "by the very nature of litigation, adverse litigants cannot be saddled with all duties which might ordinarily accompany a fiduciary relationship because it is axiomatic that a litigant cannot place the other litigant's interests above its own in all respects."[19] The court's logic – that enforcing fiduciary duties among litigation parties is paradoxical – supports a bright-line rule terminating fiduciary duties at the beginning of litigation.

More recently, the Illinois Appellate Court found that the existence of a fiduciary duty did not relieve a litigant of his own obligation to pursue his claim diligently. In *Willis Capital v. Belvedere Trading, LLC*, Willis attempted to vacate a judgment entered into pursuant to a settlement agreement, claiming that its adversaries, the other members of Belvedere, failed to disclose the existence of an alleged valuation of the company.[20] In affirming the dismissal of Willis' petition to vacate the judgment, the

Illinois Appellate Court found that Willis failed to meet its burden of demonstrating that it pursued the underlying claim diligently.[21] In so doing, the Appellate Court expressly rejected Willis' claim that its partners' alleged breach of their fiduciary duty to disclose the valuation excused Willis from pursuing disclosure of the valuation or securing one of its own in the underlying litigation.[22]

Despite the logical appeal of this bright-line rule, courts may be reluctant to hold that fiduciary duties end once *any* litigation has commenced. Fiduciary duties may help facilitate the open flow of information between business partners, and they are necessary for the functional operation of businesses. Given how long litigation can last, it may seem overbroad to some courts to cut off *any* fiduciary obligations throughout the *entire* process of litigation. Even if courts choose not to apply a bright-line rule that ends fiduciary duties between business partners when litigation begins, there is another, more focused rule that courts can use: fiduciary duties do not exist between litigating partners while in the course of settlement discussions, provided that both parties are represented by counsel. This way, the fiduciary relationship will still exist throughout parts of litigation for the sake of any ongoing business, so courts will not have concerns about an overbroad rule. At the same time, the basic purpose of the bright-line rule would still be realized. Eliminating the specter of alleged fiduciary duties during settlement negotiations and discussions will provide business partners security in knowing that they can reach finality in a settlement agreement and not be subject to litigation years later on the issue of whether information they did or did not disclose to the other party during the course of litigation or settlement discussions was "material" and, therefore, subject to the fiduciary standard of "full and frank" disclosure.

In certain contexts, courts have already recognized that reaching certain stages of litigation alters or eliminates aspects of fiduciary duties between adverse litigants. In *Strougo v. Bea Associates*,[23] the plaintiff—a shareholder of an investment company—sued the company's advisor and directors, alleging a breach of fiduciary duty in connection with a rights offering.[24] During discovery, the plaintiff moved to compel the production of various documents in the advisor's privilege log; the advisor opposed plaintiff's efforts and claimed these documents were protected by the attorney-client privilege.[25] In discussing the scope of the attorney-client privilege, the court noted that one exception to the attorney-client privilege was the "fiduciary exception," in which fiduciaries of corporations must disclose attorney-client communications to beneficiaries in the course of litigation.[26] The court in *Strougo* found that while the fiduciary exception "permits disclosure of communications relating to the conduct of an alleged action in proper circumstances, it does not permit disclosure of communications regarding the defense of a lawsuit." Similarly, the Fifth Circuit Court of Appeals in *In re International Systems & Corporate Securities Litigation.* held that there was no "fiduciary exception" to the work product doctrine.[27] The Court stated that the "fiduciary exception" was premised on a "mutuality of interest" between shareholder and management.[28] The Court reasoned, however, that "[t]wo parties anticipating litigation against each other do not have a common interest," and that "[t]o hold otherwise would be to ignore modern corporate realities."[29] Courts in multiple jurisdictions have also concluded that reaching certain stages of litigation severs fiduciary obligations between shareholders and management.[30] The rationale behind cases like *Strougo* and *International Systems* applies just as well to business partners. Just as shareholders and management anticipating litigation against one another have no mutual interest, business partners preparing for settlement have undoubtedly severed any mutuality of interest. For this reason, it is appropriate for courts to follow the logic of cases like *Strougo* and recognize that business partners who are now adverse litigants do not owe fiduciary duties to each other during settlement discussions.

Eliminating fiduciary duties in these limited circumstances between business partners would not constitute a radical change to concepts of fiduciary duties. Rather, it would acknowledge the reality of the relationship between the litigating business partners and force them to treat settlement discussions as an arms-length transaction. Like any other contract arising from an arms-length transaction, one settling party could demand that the other include specific representations in the settlement agreement. If one settling party agrees to make such a representation in the settlement contract but later violates the representation, then the other side may use the violation of an explicit contractual term as a basis for a subsequent lawsuit. On the other hand, if the party refuses to make such a representation in the settlement contract, that will give the parties an opportunity to discuss certain aspects of the settlement contract and reach a fuller understanding of each other's position. Far from ushering in a "Wild West" of settlement contracts, eliminating fiduciary duties in this situation would simply cause the settling former business partners to do what any other parties in an arms-length transaction can and should do: assume nothing, negotiate for representations in the contract, discuss their positions if they refuse to include the representations, and abide by the explicit terms of the contract.

Although courts have not yet applied a bright-line rule that cuts off fiduciary duties in such situations, they have been willing to enforce explicit contractual provisions that essentially lead to the same result. For instance, courts have routinely upheld non-reliance clauses, where parties specifically disclaim reliance on representations made by the other parties. In *Benson v. Stafford*,[31] the Illinois Court of Appeals upheld the validity of a non-reliance clause in a dispute arising out of specialist purchase agreements between Chicago Board of Exchange traders. The plaintiff in that case argued that the non-reliance clause in the agreements was an invalid exculpatory clause that attempted to shield the defendant from future wrongdoing.[32] The court rejected this argument, and explained that unlike an exculpatory clause, the non-reliance clause did not attempt to release a party from liability or limit liability for an intentional act of fraud.[33] Rather, it simply negated the element of reliance, so that "the fraud cannot occur, because the parties have agreed that there was no reliance, a necessary element for fraud."[34] Courts in other jurisdictions have regularly upheld non-reliance clauses, as well.[35]

Courts have similarly upheld non-reliance clauses in spite of parties' claims that they are unenforceable boiler plate provisions. In *Rissman v. Rissman*,[36] brothers Arnold and Randall Rissman were the co-owners of Tiger Electronics. The brothers had a falling out, and Arnold sold his shares to Randall for $17 million.[37] Thirteen months later, Tiger sold its assets to Hasbro, a toy maker, for $335 million. Arnold sued Randall under federal and state security laws, claiming that Randall misled him into believing that Randall would never sell Tiger.[38] Randall argued that because Arnold had signed a non-reliance clause stating that he had not relied on any prior oral statements as part of the transaction, and without reliance Arnold had no claim under securities laws.[39] In response, Arnold called the no-reliance clauses "boilerplate."[40] The Seventh Circuit of Appeals agreed with this characterization, but reasoned that the boilerplate state of the non-reliance clause was a reason to *enforce* it, not to disregard it, because "[p]hrases become boilerplate when many parties find that the language serves their ends," and "[p]eople negotiate for the presence of boilerplate clauses."[41] In other words, Arnold could have negotiated for the elimination of the non-reliance clause in exchange for a reduction in the price of his shares, but did not do so. Having accepted the presence of a non-reliance clause in the sale agreement, Arnold was forced to abide by it, and as a consequence was unable to bring the securities laws claims, which included "reliance" as one of their elements.

The same logic should apply to cases of breach of fiduciary duty: courts should respect any *explicit* contract in a settlement agreement that disclaims any fiduciary duty claim in future litigation. It is a widely-accepted legal concept that business partners may alter the scope of their fiduciary duties by contract.[42] In certain cases, these contractual amendments to eliminate fiduciary duties may negate an otherwise-viable claim for a breach of fiduciary duty. For instance, in *The DirecTV Group, Inc. v. Darlene Investments*,[43] Darlene Investments, a Cayman Islands limited liability company, alleged that DIRECTV violated the terms of a joint partnership between the two companies, and fraudulently induced Darlene into signing a mutual release, in violation of DIRECTV's fiduciary duties owed to Darlene.[44] The District Court for the Southern District of New York granted DIRECTV's motion to dismiss this claim.[45] The court held that Darlene failed to adequately demonstrate that a joint venture had been formed, but noted that in any case, the LLC Agreement between Darlene and DIRECTV specifically omitted a fiduciary duty provision that had been contained in an earlier agreement. The court reasoned that "[c]ontracting parties are free to eliminate fiduciary duties in a limited liability company agreement," and concluded that "once members exercise their contractual freedom in their limited liability company agreement, they can be virtually certain that the agreement will be enforced in accordance with its terms."[46] Following this logic, there should be no question that business partners, in setting the terms of their fiduciary duties, may elect to eliminate fiduciary duties during the course of settlement discussions or even throughout all litigation or the operation of their business.

But more importantly, there is no reason for courts to require contractual provisions to eliminate fiduciary duties among litigating business partners engaging in settlement discussions. Rather, this should be applied as a default rule. The logic behind cases such as *Benson v. Stafford* is that some event (in *Benson*, a non-reliance clause) has negated an essential element of the claim for fraud. Similarly, parties may alter fiduciary duties by contract in a way that negates potential claims for breach of fiduciary duty. But in cases where business partners have seen deterioration in their working relationship and are discussing a settlement agreement to finalize the termination of their partnership, there is no need to require a contract to negate the elements of a claim for breach of fiduciary duty. As discussed above, the basic prerequisite for a fiduciary duty is a relationship of mutual trust. Unquestionably, litigation between parties nominally in a fiduciary relationship with one another destroys any trust between the parties. Thus, the predicate for a claim for breach of fiduciary duty – the existence of a fiduciary duty – does not exist.[47] For this reason, just as courts have held that non-reliance clauses can prevent a cause of action for fraud, courts should also hold that former business partners who are engaging in settlement discussions no longer have a fiduciary relationship, thereby preventing future lawsuits involving claims of a breach of fiduciary duty.

An unfortunate reality of doing business is that business relationships can sour. Generally, parties prefer to sever a failing relationship effectively, and with finality, by signing a settlement agreement that includes a release of all legal claims, past and present, that the parties may have against one another. Some courts have undermined the effectiveness of these settlement agreements by holding that business partners owe one another a duty of full disclosure, even after the working relationship has deteriorated and parties are discussing settlement options. The upshot of this rule is that disgruntled former business partners can get a second bite at the apple, even after signing a settlement agreement, by claiming that their business partners withheld material information during settlement discussions. Moreover, such a rule ignores the reality of litigation between business partners, who no longer share common interests or a relationship based on trust. In order to ensure finality of settlement agreements, and end needless (and sometimes endless) litigation, courts should apply a bright-line rule making it clear that business partners who are adverse parties in litigation have no fiduciary duties to one another. Courts could draw a bright-line rule: at the beginning of litigation and at the beginning of settlement discussions. In addition, courts should at the very least consistently enforce the agreed-upon terms in a settlement agreement, such as non-reliance clauses. Wherever courts choose to draw the line, the result will be a rule that discourages follow-on lawsuits and encourages efficient and secure settlements.

[1] *Borsellino v. Putnam*, 962 N.E. 2d 1000, 1005 (Ill. App. Ct. 1st Dist. 2011).

[2] *Id.* at 1005-06.

[3] *Id.* at 1006.

[4] *Id*. at 1014.

[5] *Id.* at 1119.

[6] *Golden v. McDermott, Will & Emery*, 702 N.E.2d 581, 585 (Ill. App. Ct. 1st Dist. 1998).

[7] *Cwikla v. Sheir*, 801 N.E.2d 1103, 1112 (Ill. App. Ct. 1st Dist. 2003) (citing *Golden*, 702 N.E. 2d 581).

[8] *Compton v. Kirby*, 577 S.E.2d 905, 914 (N.C. Ct. App. 2003).

[9] Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limits of the Doctrine*, 22 Cardozo L. Rev. 51, 60 (2000).

[10] *Tex. Std. Oil & Gas, L.P. v. Frankel Offshore Energy, Inc.*, 394 S.W.3d 753 (Tex. App. 2012).

[11] *Id.* at 756.

[12] *Id.* at 757.

[13] *Id.* at 758.

[14] *Id.*

[15] *Id.* at 759.

[16] *Id.* at 761-62.

[17] *Id.* at 762.

[18] *Id.* at 777.

[19] *Id.* at fn. 15.

[20] *Willis Capital v. Belvedere Trading, LLC*, 29 N.E.3d 1078, 1083 (Ill. App. Ct. 1st Dist. 2015).

[21] *Id*. at 1085.

[22] *Id*.

[23] *Strougo v. Bea Associates*, 199 F.R.D. 515 (S.D.N.Y. 2001).

[24] *Id.* at 518.

[25] *Id.* at 519.

[26] *Id.* at 524.

[27] *In re Int'l Sys. & Corp. Sec. Litig.*, 693 F.2d 1235, 1239 (5th Cir. 1982)

[28] *Id*.

[29] *Id.*

[30] *See, e.g.*, *Hutchinson v. Farm Family Cas. Ins. Co.*, 867 A.2d 1, 10 (Conn. 2005); *Garvy v. Seyfarth Shaw LLP*, 966 N.E.2d 523, 525 (Ill. App. Ct. 1st Dist. 2012); *Herrmann v. Rain Link, Inc.*, 2012 U.S. Dist. LEXIS 50553, at *24-25 (D. Kan. 2012).

[31] *Benson v. Stafford*, 941 N.E.2d 386 (Ill. App. Ct. 1st Dist. 2010).

[32] *Id*. at 408.

[33] *Id*. at 409.

[34] *Id*.

[35] *See, e.g., Barr v. Dyke*, 49 A.3d 1280, 1289 (Maine 2012); *RAA, Mgmt., LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107 (Del. 2012); *Finn v. Prudential-Bache Secs., Inc.*, 821 F.2d 581, 586 (11th Cir. 1987) (applying Florida law).

[36] *Rissman v. Rissman*, 213 F.3d 381 (7th Cir. 2000).

[37] *Id.* at 382.

[38] *Id.*

[39] *Id.* at 383.

[40] *Id.* at 385.

[41] *Id.*

[42] *See, e.g.,* 6 Del. C. § 15-103 (subject to certain exceptions, relations among partners are subject to the partnership agreement that partners write).

[43] *The DirecTV Group, Inc. v. Darlene Investments*, 2006 U.S. Dist. LEXIS 69129 (S.D.N.Y. 2006).

[44] *Id.* at *6-7.

[45] *Id.* at *22.

[46] *Id.* at *19 (quoting *Walker v. Res. Dev. Co. Ltd., LLC*, 791 A.2d 799, 813 (Del. Ch. 2000)).

[47] *See, e.g., Barr*, *supra* note 30, at 1289 ("when parties in a fiduciary relationship have become adversaries and are seeking to settle a dispute, they ordinarily have discarded the relationship of trust in pressing the dispute; certainly they have done so by the time they are entering into an agreement disclaiming reliance in settlement of litigation").

National Law Review, Volume V, Number 201

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