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News & Types: Corporate, Finance & Acquisitions Update

Business Owner Loses $30 Million Through Lack of Due Diligence

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Practices: Corporate, Finance & Acquisitions, Litigation

William Carlson was a successful businessman. Carlson was the owner of Willis Capital LLC, through which he founded Belvedere Trading LLC in 2002, using his life savings of $405,000. (In this Update, we will refer interchangeably to Willis Capital LLC as Willis and to Carlson, the individual who set up Willis to invest in Belvedere.)

Later, Thomas Hutchinson and Owen O'Neill joined Belvedere, with Hutchinson investing $85,000 and O'Neill $160,000. In February 2008, Hutchinson and O'Neill acquired Willis's interest in Belvedere for $17.5 million. So Carlson did very well with his investment. But, three years later, Carlson claimed his investment should actually have been valued at $49.8 million and he sued his former partners for more. He lost. What happened? It seems that Carlson, successful though he was, was not attentive enough when it came to negotiating and selling his interest in Belvedere. (*Willis Capital LLC v. Belvedere Trading LLC, Thomas Hutchinson and Owen O'Neill,* Illinois Court of Appeals, 1-13-2183 & 1-14-0381, March 16, 2015)

After an apparently successful five year run with Belvedere, Carlson had medical issues that prevented him from being more active in the management of Belvedere. His partners, Hutchinson and O'Neill, took control of Belvedere. Far from being sympathetic to Carlson's condition, they used their position to deny Carlson and his LLC, Willis, access to Belvedere's assets, opportunities, and benefits.

In May 2007, Willis filed a request for arbitration with the Chicago Board of Exchange (CBOE) as provided in Belvedere's Operating Agreement. Willis wanted to dissociate from Belvedere and have its membership interest purchased at its fair value. Willis also asked Hutchinson and O'Neill to obtain an appraisal of Belvedere, but they refused. That was not all, as Hutchinson and O'Neill continued to deny Willis access to Belvedere's books and records.

But Hutchinson and O'Neill were playing a double game. Without telling Willis or Carlson, they engaged a Chicago accounting and appraisal firm, Horwich, Coleman and Levin (HCL) to determine a market value for Willis's one-third interest in Belvedere. HCL developed statistical models and presented these to Hutchinson and O'Neill. But Hutchinson and O'Neill asked HCL not to prepare a written report and to stop further work. None of this was disclosed to Willis or Carlson.

Later, in February 2008, Willis asked for an appraisal of Belvedere. But Hutchinson and O'Neill deceptively answered that an appraisal was unnecessary since Hutchinson and O'Neill did not want to sell their interests in Belvedere. After a three hour meeting, Carlson agreed to sell all of Willis's interest in Belvedere to Hutchinson and O'Neill for $17.5 million, including $4.2 million in the capital account plus $13.3 million, which was Willis's share of Belvedere's trading profit for 2007.

In March, 2008, counsel for Hutchinson and O'Neill presented a settlement agreement to all of the parties. This settlement agreement came back to haunt Willis and Carlson. Under the settlement agreement, Carlson and Willis broadly released Hutchinson and O'Neill. The settlement agreement further provided that the agreement represented a compromise and "each party fully assumes the risk that the facts or the law may be other than they believe." The agreement went on to state that all parties were advised by their attorneys. No party was relying on any promise, representation or disclosure of any other party. Finally, there was a fee shifting provision in which the prevailing party would be entitled to attorneys' fees "in an action . . . to enforce the terms" of the agreement.

Three years later, Carlson and his counsel were researching a matter related to the case when they contacted HCL, the appraiser Hutchinson and O'Neill has used in 2008. Carlson had no knowledge of the earlier appraisal and the court does not explain what prompted Carlson to contact them. But Carlson was obviously unhappy with what he discovered.

Carlson caused Willis to file a legal malpractice claim against its former counsel, claiming it failed to obtain an appraisal in 2008 and "permitted their clients to settle without any appropriate advice and counsel as to what was being surrendered." Willis also filed an arbitration action against Hutchinson and O'Neill with the CBOE on May 1, 2011. Hutchinson and O'Neill sought to dismiss the arbitration which the CBOE granted with prejudice on March 5, 2012.

Willis then filed an action in Illinois state court to reopen the 2008 settlement agreement on the basis of fraud and breach of fiduciary duty. As part of this action, Carlson (finally!) retained an expert to appraise the value of Belvedere. This expert concluded that Carlson's "uncompensated value" based on Belvedere's 2007 financials was $49.8 million. But, in a crucial observation, the court said the expert relied on Belvedere documents "created between 2004 and 2008 . . . and Willis had these documents in its possession at the time of the settlement agreement" in 2008.

The court dismissed Willis's action in June, 2013. On top of all this, the trial court awarded Hutchinson and O'Neill $170,000 in attorneys' fees based on the fee shifting provision in the settlement agreement. Willis appealed.

The appeals court obviously had sympathy for Carlson and his company, Willis. But, in the end, Carlson's sympathetic story carried no weight.

To prevail on appeal, Willis and Carlson had to show that they acted reasonably and not negligently in the original action. They also had to show that the evidence to reopen the case was not known to them at the time of the original proceeding "and could not have been discovered by [him] with the exercise of reasonable diligence."

Carlson and Willis clearly did not meet this standard. First, they never tried to obtain an appraisal prior to the 2008 settlement agreement, even though the appraisal they eventually obtained, when it was too late, was based on information available to them in 2008. Second, Carlson had reason to be suspicious of his business partners, Hutchinson and O'Neill, given their resistance to providing information to Carlson and Willis.

> "Empathy aside, Willis must meet the necessary legal requirements in order to prevail on its petition. Failing to do so, we cannot extricate Willis from the natural consequences of a bad business decision. The trial court did not err in finding that Willis failed to exercise due diligence in the settlement proceedings."

Willis also argued that Hutchinson and O'Neill owed a fiduciary duty to Willis. The appeals court never stated whether it agreed or disagreed with this assertion. But, even if Hutchinson and O'Neill owed Willis a duty to disclose and fraudulently concealed the appraisal that Hutchinson and O'Neill obtained, it did not excuse Willis's lack of due diligence at the time of the 2008 settlement.

But the appeals court did eventually give a break to Willis and Carlson. Recall that the trial court awarded attorneys' fees to Hutchinson and O'Neill based on the fee shifting provision in the settlement agreement, awarding the prevailing party attorneys' fees in a suit to enforce the settlement agreement. This cost Willis $170,000 in attorneys' fees.

The appeals court reversed the award of attorneys' fees using reasoning that seemed weak but also seemed clearly intended to avoid further punishment to Willis and "poor" Mr. Carlson. According to the court, fee shifting provisions are strictly construed by courts. Here, the settlement agreement provided that "[i]n an action brought by any party to enforce the terms hereof, the prevailing party shall be entitled to recover its reasonable legal fees and expenses . . . ." But Willis's suit sought to invalidate the settlement agreement, not to enforce it. The defendants, Hutchinson and O'Neill, defended the agreement, but were not seeking to enforce it. So the award of attorneys' fees was in err and the appeals court reversed this decision.

Of course, we can sympathize with Carlson's and Willis's plight and still disagree with the court's reasoning. It seems that fee shifting provisions can work when the party enforcing the agreement is "playing offense" in enforcing the agreement. But parties "playing defense" and defending such agreements from attack are apparently on their own. The result may encourage dissatisfied parties, who may be less sympathetic than Carlson and Willis, to attack such agreements with no concern about paying the other side's legal fees. The distinction drawn by the appeals court, that playing offense to enforce such an agreement will trigger attorneys' fees but not when defending such an agreement from attack, may be harder to apply in a more difficult case.

In any case, Carlson and Willis, while perhaps the victims of deception and concealment, were not compensated because of their lack of due diligence, failure to use information available to them to obtain an appraisal and, perhaps, failing to heed warning signs that their business partners, Hutchinson and O'Neill, may not have been totally honest with them. The appeals court, while sympathetic, could not allow Carlson and Willis to escape the consequences of their own action and inaction.