Business Litigation

# Should Tom Petters' Legal Defense Costs Be Paid by the Corporations That He Harmed?

By Janel Dressen

The headline to this article is probably more dramatic than necessary to make the point. But the reality of Minnesota law, as interpreted by a recent Minnesota district opinion, is that officers and directors accused of wrongdoing against their corporations may have their defense costs advanced by the *defenseless* corporation.

Historically, the risk of personal liability for directors has been cited as presenting an obstacle to recruiting and retaining qualified individuals to serve as corporate directors. In large part to address this concern, Minnesota enacted a statute in 1981 that requires, as a default, the mandatory advancement of legal and other expenses by the corporation to directors, officers *and* employees made or threatened-to-be-made parties to proceedings by reason of their former or present official capacity if they satisfy the specified statutory standards. Minn. Stat. § 302A.521, subds. 2, 3. The statute stands for the proposition that the noblest of intentions sometimes result in unintended and harsh consequences.

Needless to say a corporation's board is often surprised and corporate counsel chagrined when they discover that under the statute, a director, officer or an employee is entitled to have their defense costs advanced even when they have been accused by the corporation of misconduct. The right to mandatory advances –the funding of the entitled person's legal fees and expenses as they are incurred – applies even when directors, officers or employees are accused (and in some cases proven guilty) of criminal conduct and/or corporate wrongdoing. Under the statute, the right to an advance is determined at the time the advance is requested. That request almost always occurs before the final adjudication of the issues in question.

To highlight the practical application of the default rule, consider the following facts. Shareholder A is a 50 percent owner, director, officer and employee of a two-person corporation who discovers that his 50 percent co-owner, Shareholder B, who is also a director, officer and employee, has engaged and continues to engage in conduct contrary to his statutory and common law obligations to the company. Shareholder A sues Shareholder B for breach of fiduciary duty. Shareholder B responds by requesting advances of his legal expenses to defend himself. Is Shareholder B, the alleged wrongdoer, entitled to the payment of his legal fees by the very company he is alleged to have harmed, while Shareholder A is required to pay his own legal fees in seeking to protect the company? The trial court in *Hinshon v. Westlake,* Henn. Co. Ct. File No. 27-CV-12-5777 (10/31/12) answered this question: yes.

In *Hinshon,* the district court addressed several unanswered questions associated with this simplified fact pattern in deciding defendant's motion for advances. First, the court noted that while the statute

Janel Dressen is a shareholder of Anthony Ostlund Baer & Louwagie P.A. where she represents businesses, directors, officers, shareholders and employees in all aspects of commercial litigation and dispute resolution, with an emphasis on director and officer, corporate governance, shareholder, partnership, employment and contract disputes. Ms. Dressen also counsels businesses regarding risk management and avoidance, corporate governance, employment matters and insurance coverage. Ms. Dressen can be reached at (612) 349-6969 or jdressen@aoblaw.com.

puts the burden of proof on the party requesting advances, it does not identify the applicable standard of proof. The court found it significant that the statute requires the person requesting advances to provide a written undertaking to repay all amounts advanced by the corporation if it is ultimately determined that the statutory criteria to indemnification have not been satisfied. The court said that, in its opinion, "the legislature contemplated two different standards of proof: an initial lower showing threshold (prima facie), and one later higher standard [for indemnification] (preponderance of the evidence). If the legislature had intended only one standard to apply, there would be no need for the defendant to promise to repay the advances in the event of a later adverse factual finding." *Hinshon, supra.*

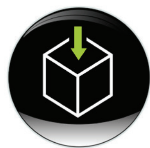
It was of no consequence to the court that the person providing the undertaking may lack the resources to repay the advance. The statute does not require a demonstration by the defendant who receives the advances that he or she has sufficient assets to repay the advances or the posting of a bond to guarantee repayment to the corporation. Moreover, the court noted that advances are required even if that means the corporation could not meet its other financial obligations.

The court also concluded that the only way to defeat a motion for advances based upon the underlying facts before trial is if the facts are *undisputed.* If this position is adopted as controlling law in Minnesota, the successful denial of an advances request will be even more difficult since most of these cases are very fact-intensive and disputed, and the right to advances is almost always made before a final adjudication of the merits.

Importantly, the advances statute empowers a corporation to opt out of the *mandatory* requirements by eliminating, limiting or conditioning the receipt of advances. As just a few examples, a company could eliminate the right to advances in proceedings commenced by the corporation, limit the right to advances to directors only, limit the right to advances based upon the financial condition of the corporation as determined by an appropriate formula or condition advances upon receipt of security or a bond for the repayment obligation in an acceptable form.

Experience in litigating cases involving advance requests teaches that corporations should give serious consideration to incorporating appropriate opt out provisions to the mandatory advances statute so that the corporations are not unwittingly exposed to the substantial risk of having to advance defense costs in unintended situations.


Digital Evidence Specialists



• Expert Witness Testimony that judges & jurors understand
• Preservation, Analysis & Presentation of Electronic Evidence
• Liaison with Law Enforcement
• Incident Response
• Complimentary CLE Training

601 Carlson Parkway, Suite 1250
Minnetonka, MN 55305
**(952) 924-9920**
**info@compforensics.com**

www.compforensics.com