

D&O News Flash

District Court in Manhattan Rules that Certain Prosecutorial Tactics Violate Constitutional Rights of Employees

In a decision handed down yesterday in the case *U.S. v. Stein, et al.*, 2006 WL 1735260 (S.D.N.Y. June 26, 2006), United States District Court for the District of New York Judge Lewis A. Kaplan ruled that certain tactics used by the government in prosecuting cases of corporate misconduct violated the constitutional rights of employees involved in these criminal investigations.

Specifically, the decision dealt with the advancement of legal fees to employees being investigated in connection with the government's prosecution of former partners of KPMG for selling abusive tax shelters. Traditionally, companies have paid these legal fees. In fact, laws of certain states and many corporate by-laws require it. However, in 2003, a Justice Department document, commonly known as the Thompson Memorandum (which was written after the indictment and resulting collapse of Arthur Andersen), has been subsequently interpreted by defense and corporate lawyers to mean that companies can curry favor with prosecutors if they agree to stop paying the attorneys' fees incurred by employees while under investigation. Particularly, one of the conditions cited in the memo states that a company must demonstrate it is fully assisting the government in its investigation. And, if the company is paying the attorneys' fees of the scrutinized investigation, prosecutors could view the company as not being fully cooperative. In turn, prosecutors have argued that the memo is simply a set of guidelines for prosecutors to consider, and not requirements that are set in stone.

Judge Kaplan, coming down on the side of the defense and corporate lawyers' arguments cited above, ruled that KPMG was essentially unconstitutionally coerced by the government to stop paying the attorneys' fees of its employees under investigation. In other words, as Judge Kaplan emphatically stated in his opinion, KPMG stopped paying its employees' attorneys' fees "because the government held the proverbial gun to its head."

Indeed, Judge Kaplan went as far as to say that during its negotiations with KPMG, federal prosecutors, in implementing the guidelines set forth in the Thompson Memorandum, "interfered with the rights of [the employees under investigation] to a fair trial and to the effective assistance of counsel and therefore violated the Fifth and Sixth Amendment to the Constitution."

Judge Kaplan refused to throw out the government's claims for conspiracy and accounting fraud, but did state that the employee defendants could file civil suits against KPMG for its refusal to pay their legal fees.

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While it is true that this opinion applies only to this specific case, and may (and most likely will be) appealed, Judge Kaplan's decision may signal a turning of the tide of what many believe to be the carte blanche given to federal prosecutors in investigating corporate scandals after the fall of Enron. Accordingly, it is clear that this decision alone will not only affect (and indeed may even completely force the government to rethink) the tactics prosecutors use in investigating corporate scandals, but it will most certainly influence future decisions by companies regarding whether to indemnify its employees.

In sum, it appears that this decision represents a positive development and has significant implications for companies and their directors and officers.

Directors & Officers Department

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