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OR A VIOLATION OF CONSTITUTIONAL RIGHTS?**

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Pressuring Companies to Cut Off Employee Indemnification: Good Faith Cooperation or a Violation of Constitutional Rights?

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The defense bar has been closely watching several recent, high-profile investigations in which the government has successfully pressured companies to jettison certain employees and to refuse to indemnify those employees for their legal representation—even though they have not been convicted of a crime. The Department of Justice's Thompson Memorandum (Thompson Memo) explicitly sanctions and even encourages this tactic as part of the government's evaluation of the extent of a company's cooperation. Corporate counsel and the white collar crime defense bar, however, have expressed grave concern with the government's position on the grounds that in complex white collar matters the refusal to indemnify employees for their legal fees is tantamount to a denial of the right to effective assistance of counsel. Some courts have agreed. In fact, a federal judge recently held that the Thompson Memo and the manner in which the government used it to discourage KPMG from paying the legal fees of its former employees was unconstitutional.

The Thompson Memo, issued in January 2003, outlined the criteria federal prosecutors would use when determining whether to indict a corporation.¹ It, like the United States Securities and Exchange Commission's (SEC's) Seaboard Report,² emphasizes the importance of timely and extensive cooperation in seeking a favorable outcome for the corporation. Under the memo, federal prosecutors must scrutinize the depth and quality of a company's actions to gauge the extent of its cooperation. Prosecutors may consider whether the corporation "appears to be protecting its culpable employees and agents," including whether the corporation is advancing attorneys' fees.³ Although the memo recognizes that some corporations are required under state law to pay for the legal fees of officers under investigation, unless and until a formal determination of their guilt, it is silent as to whether a corporation's permissive indemnification of employees under governing law will be considered a failure to cooperate.⁴

¹The Thompson Memo superseded the Holder Memorandum issued in 1999 by the then Deputy Attorney General Eric Holder, Jr. The primary focus of the Thompson Memo "is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation." Deputy Attorney General Larry D. Thompson, U.S. Dept. of Justice, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

²Report of the Investigation Pursuant to 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Rel. No. 44,969, 2001 WL 1301408 (Oct. 23, 2001).

³Thompson Memo, *supra*, at VI.B n.1.

⁴*Id.* at VI.B. n.4.

In practice, the government has “encouraged” cooperation by pressuring companies to break faith with their employees. Federal prosecutors have reportedly pressured companies to refuse to pay the legal fees of employees or risk being branded as uncooperative. HealthSouth Corp. withheld attorneys’ fees to former chief executive Richard Scrushy after being informed that advancing fees would be viewed as a sign of noncooperation.⁵ Symbol Technologies Inc. was able to pay only the attorneys’ fees of indicted executives after it demonstrated that it was required to do so by company bylaws.⁶ Lucent Technologies, on the other hand, was actually subjected to a \$25 million penalty, in part, for its decision to indemnify certain employees who were unwilling to settle the SEC’s claims against them.⁷

Now, the tide may be turning. In two recent federal criminal prosecutions, the government has been chastised by the courts for pursuing this strategy. In *United States v. Gagalis, et al.*,⁸ an accounting fraud case in the U.S. District Court for the District of New Hampshire, Judge Paul Barbadoro, who is presiding over Enterasys Networks’ accounting fraud trial, expressed concern that prosecutors had wrongly pressured the company to refuse to pay the legal fees of its former employees.⁹ During a pretrial hearing, the company argued that, although it had the right to promise to advance legal fees to its employees, this obligation was only a “rebuttable presumption” and not unconditional.¹⁰ Judge Barbadoro characterized this argument as “border[ing] on the absurd” and indicated that he was skeptical of the prosecution’s assertion that it did not pressure the company to withhold attorneys’ fees.¹¹ At the conclusion of the hearing, Enterasys agreed to pay past-due legal bills and cover the future legal costs of its former employees. Although Judge Barbadoro admonished the government and suggested that defense counsel file a complaint, he did not sanction the prosecution.

On the heels of Enterasys, U.S. District Court Judge Lewis A. Kaplan took the matter further—he found the government’s conduct unconstitutional. In *United States v. Stein, et al.*, several defendants who were former employees of KPMG claimed that the government had pressured KPMG “not to pay legal fees for any partners indicted on criminal charges, even if they had ‘cooperated’ with the government.”¹² The government argued that it never pressured or required KPMG to withhold legal fees and that KPMG

⁵Nathan Koppel, *U.S. Pressures Firms Not to Pay Staff Legal Fees*, W.S.J., March 28, 2006, at B1.

⁶*Id.*

⁷Press Release, U.S. Securities & Exchange Commission, *Lucent Settles SEC Enforcement Action Charging the Company with \$1.1 Billion Accounting Fraud*, available at <http://www.sec.gov/news/press/2004-67.htm>.

⁸No. 1:04-00126 (D.N.H. filed May 19, 2004).

⁹Koppel, *U.S. Pressures Firms Not to Pay Staff Legal Fees*.

¹⁰Bob Sanders, *Prosecution Grilled at Enterasys Hearing; Trial Set for June 6*, N.H.B.R., March 17, 2006.

¹¹*Id.*

¹²*Federal Judge Criticizes KPMG Case Prosecutors*, L.A. Times, March 31, 2006.

was free to do what it wanted to do. During detailed evidentiary hearings on the matter, Judge Kaplan described the government’s assertion that KPMG was not pressured to cooperate as “lame.”¹³ He reminded the government that the defendants were innocent until proven guilty and that they had the right to counsel under the Sixth Amendment. He further asked the government “what legitimate purpose” was served by its policy, called its actions “shameful” and commented that it was “depriving people of counsel, or at least interfering or impairing [access to counsel].”¹⁴ Judge Kaplan said companies under investigation ought to be free to decide whether to support their employees or former employees without the government’s “thumb on the scales [of justice].”¹⁵ After hearings and lengthy briefings on the matter, Judge Kaplan issued a blistering written opinion. Judge Kaplan found that “KPMG refused to pay [the defendants’ legal fees] because the government held the proverbial gun to its head.”¹⁶ Judge Kaplan wrote that the government’s promise to look “under a microscope” at any payment of attorneys’ fees in deciding whether to indict KPMG was tantamount to requiring KPMG not to pay. The court found that the Thompson Memo and the manner in which the government used it interfered with the due process rights of KPMG’s former employees to a fair trial and to the effective assistance of counsel. Therefore, Judge Kaplan ruled that the government violated the Fifth and Sixth Amendments to the Constitution.¹⁷ Moreover, his opinion went so far as to admonish the U.S. Attorney’s Office for attempting to mislead the court about the extent of influence it exerted over KPMG.¹⁸

Judge Kaplan also found that indemnification rights of the KPMG defendants to have their defense costs advanced may be protected by contract implied in fact by KPMG’s uniform past practice of paying defense costs of their employees. Fashioning a unique remedy—absent KPMG stepping forward immediately to advance costs of the prosecution to its former employees—Judge Kaplan took ancillary jurisdiction over a civil docket and instructed the KPMG defendants to file claims against KPMG for advancement of defense costs,¹⁹ a move that leaves little doubt KPMG’s former employees will be indemnified in connection with this prosecution.

The Enterasys and KPMG cases may indicate that the pendulum is shifting in a more defense-friendly direction and that prosecutors and enforcement lawyers may be required

¹³Editorial, *Corporate Injustice*, W.S.J., Apr. 6, 2006, at A14.

¹⁴*Id.* In fact, an impressive list of amici curiae weighed in with the court on the significant business benefit served by indemnification. These included The Securities Industry Association, The Association of Corporate Counsel, the Bond Market Association, and the Chamber of Commerce of the United States of America. See also Lynnley Browning, *Judge Questions Clarity of Prosecution’s Tax-Shelter Case*, N.Y. Times, March 31, 2006 at C4.

¹⁵Browning, *Judge Questions Clarity of Prosecution’s Tax-Shelter Case*.

¹⁶*United States v. Jeffrey Stein et al.*, No. S1 05 Crim. 0888 at 2 (S.D.N.Y. June 26, 2006).

¹⁷*Id.* at 82-83.

¹⁸*Id.*

¹⁹*Id.*

to take a more measured, reasonable approach when companies decide whether to indemnify employees who have not been convicted of wrongdoing. Only time will tell whether other courts will follow suit or whether the government will temper its approach. If the government fails to change its approach to this issue, however, particularly in light of Judge Kaplan's explicit criticism of the element of coercion implicit in the government's tactics, there will undoubtedly be further scrutiny of the Thompson Memo criteria for corporate cooperation by the courts.²⁰ One thing is certain—the government is now acutely aware that the courts are taking notice of these discussions, which until now seemed to be beyond any serious judicial review.

Although the Enterasys and KPMG cases are significant developments for companies and their employees who find themselves in the government's cross hairs, companies should continue for the time being to take a cautious and consistent approach to these issues as overly broad assertions of corporate representation of employees or former employees may still be viewed as impediments to the government's investigation. On the other hand, as these cases recognize, although consideration must be given to the government's position, companies cannot and should not ignore the fundamental rights of its employees or its legal obligations to those employees that the government has labeled potentially culpable. They are, after all, innocent until *proven* guilty.

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²⁰The implementation of the Thompson Memo as it relates to the indemnification of employees is not the only provision of the Thompson Memo under heightened scrutiny. The government's routine demands for waiver of the attorney-client privilege and work product protection by companies under investigation has been the subject of much debate among diverse legal groups over the past few years. Recently, the U.S. Sentencing Commission voted unanimously to reverse the 2004 privilege amendment that tied credit for cooperation and disclosure to waiver of the privilege. The Department of Justice is now under increased pressure to implement changes to its waiver policies.