



INDIVIDUAL LEGAL EXPENSES: SHOULD YOU HAVE A POLICY?

In his June 2006 decision in the KPMG criminal case, New York federal Judge Lewis Kaplan ruled that the government's use of the 2003 Thompson Memorandum to force withdrawal of legal-expense payments to former KPMG personnel defending criminal charges violated their Fifth and Sixth Amendment rights. While company counsel have good reason to cheer this judicial criticism of the government's heavy handed tactics, the case also raises important practical considerations for every business.

The Elemental Issues

Demands for coverage of the legal expenses of individual personnel arise in internal investigations, as well as external investigations and litigation. The issues are, of course, most intense when there are external pressures on personnel. Five elemental issues are common to all situations in considering a policy for paying an individual's legal expenses incurred because of his conduct for the business:

1. Should the company adopt a definitive policy, or leave all decisions to *ad hoc* determination?
2. If a definitive policy is adopted, is the decision to pay mandatory or discretionary?
3. Whether the policy is mandatory or discretionary, is payment dependent on certain conditions?
4. Is payment by "advance," or is the individual only covered by "indemnification?"
5. Who is covered?

Some state statutes limit the range of choice under these issues; most do not. Assuming that the applicable statute is permissive, *e.g.* Delaware's law, a company has a wide range of choice to fashion a policy.

Definitive or *Ad Hoc*

A definitive policy provides the benefit of a clear statement to recruits and interested personnel of the circumstances under which their legal expenses will be paid, thus both providing hiring incentives and avoiding disagreements when a later request is made. While the absence of a definitive policy provides flexibility, complaints of arbitrary management decisions and government suspicions of manipulation can create

unnecessary risks when the company is facing the challenges of an investigation or litigation.

Mandatory or Discretionary

A mandatory policy that requires a company to pay the legal expenses for specified personnel provides maximum confidence of legal protection. It also will avoid pressure from the government to withhold payment, since the Thompson Memorandum states that mandatory payments will not be considered as a “cooperation” factor. However, because the financial risk of mandatory payments may be too great to undertake in the vacuum of initial policy creation, the company may want to consider conditions that moderate the risk.

While a stated policy giving the company the discretion to pay an individual’s legal expenses carries the benefit of providing flexibility to tailor payments according to the company’s interest in each instance, it carries disadvantages, as well. The government will consider – openly or subtly – any discretionary payment to suspected individuals as non-cooperation. Payments to some and not others in the same matter may also create unnecessary enemies. And, a consistent practice of paying the legal expenses of one category of personnel – *e.g.* directors and senior management – may be found, as in the KPMG case, to create an obligation to pay all personnel in those categories in every instance, thus converting discretionary choice into mandatory agreement.

Conditions

Conditions imposed on payment of an individual’s legal expenses should be tailored to the particular business. The most commonly considered conditions require:

- Full cooperation in response to any request from the company;
 - Full cooperation includes full disclosure of documents and information;
 - Full cooperation excludes assertion of any privileges, including constitutional and counsel privileges;
- Full cooperation with any government investigation;
- The absence of a determination by the company that the individual has violated a law, regulation or company rule;
- The absence of an adverse position taken by the person against the company;
- The absence of a regulatory charge or claim;
- The absence of a criminal charge;
- Agreed disgorgement of payments upon a company or official finding of a violation of a law, regulation, or company rule;
- Company approval of the individual’s counsel.

Full Cooperation

Full cooperation with the company is both reasonable and required for effective compliance. Full cooperation with a government investigation is another matter, as the

determination of cooperation will be heavily influenced by the government's view, not only of the individual, but also of its prosecutorial priorities. For example, if the government believes that its investigation will be advanced by comprehensive cooperation from a particular individual – regardless of her personal exposure – and if that person has counsel paid by the company who is resisting the government's demands, the government can add to its already considerable pressure for cooperation its conclusion that the individual is not cooperating with its investigation and is, therefore, not entitled to expense payments under the company's own policy. These considerations apply equally where there is a condition requiring the absence of a criminal charge. If the company believes the individual is innocent, or, if the company itself is defending a criminal charge, such a condition could seriously hinder protection of the company's institutional interest.

Where the person whose legal expenses are being paid takes a position adverse to the company in the matter for which payments are being made, the company may reasonably conclude that continuation of payment would be directly contrary to its interests and the interests of its owners. An express condition covering this possibility avoids later misunderstanding. The Company should be careful, however, not to exercise its discretion under the condition in a way that appears to be influencing the person's position.

Privilege Waiver

Waiver of privileges introduces multiple uncertainties, the complexity of which would far exceed the purpose and space of this note. Suffice to say that an official's or employee's assertion of her Fifth Amendment privilege, either directly to the government or indirectly through the company, can affect the company's interest at any point along the spectrum between full benefit and full harm. The impact is case-specific. Careful consideration should, therefore, be given to imposition of a condition giving the company the discretion to withdraw payment coverage if an individual invokes her right to remain silent in response to any inquiry made by the government. The company may, of course, choose not to exercise that discretion where the individual's refusal is either neutral or beneficial to the company. As with a cooperation condition, the company should take care not to exercise its discretion in a manner that could reasonably be considered a manipulation of the individual's position.

As a general proposition, assertion of attorney-client privilege or work-product protection should be allowed where it applies to confidential communication with the individual's personal lawyer, as those communications are integral to the attorney's representation of the individual. Conditions allowing flexibility in payment should, however, be considered where the privilege assertion applies to communications with counsel for the company.

Conditions Based on Conclusions of Violation

While a condition allowing the company to withdraw, or require disgorgement, of legal-expense payments upon its own conclusion of a violation of law, regulation, or company policy, may reduce the attraction of the expense-payment protection, retaining that authority is important in demonstrating that the company can and will police its own – an essential element under federal rules for business compliance. Such a policy also gives the company a defense against retaliatory discharge complaints where the company’s investigative and decisional process has been reasonable. A judicial conclusion of violation should also be considered a condition of payment. By contrast, adding a provision conditioning legal-expense payment on a government conclusion of violation carries the risk of the unintended consequences and external control noted above.

Disgorgement

It seems only reasonable, and some state statutes require, that an individual found to have engaged in willful or criminal conduct must disgorge his advanced legal expenses. The primary concern in imposing a disgorgement condition is the identity of the authority that will make the decision. A judicial decision is a minimum. Consistent with the discretion to begin payments, a company should also consider retaining the authority to decide that an individual must pay the company back upon the company’s own conclusion of a violation. Requiring disgorgement upon a government investigator’s or prosecutor’s allegation of wrongdoing raises the uncertainties and difficulties already noted.

Advance or Indemnification

Indemnification or reimbursement merely means payment sometime. If that is all the policy provides, a company may properly wait until all matters are concluded before paying anything. Yet, as Judge Kaplan observed, the requirement for experienced and competent counsel in most investigations and litigation cannot be met by a conditional assurance that counsel will only be paid if she succeeds in getting her client a pass. Particularly in business matters, effective counsel requires current payment. Accordingly, thoughtful corporate policies provide, not merely for indemnification, but also for advancement of legal expenses as they are incurred, with the proviso that they will be disgorged if wrongdoing is found. It is true that little is likely to be left to disgorge after a conviction; but that is what insurance is for – assuming the recent convictions of Ebbers, Lay and Skilling do not eliminate affordable D&O coverage.

Approved Counsel

While it may be a generally accepted element of providing counsel for company personnel that the individual must choose counsel from a company list or counsel whom the company will approve, the practice may create serious ethical issues, as well as prosecutorial disapproval. To be sure, the company has a legitimate interest in paying only competent counsel. It does not, however, have a legitimate interest beyond that in conditioning payment on its approval of the counsel’s strategy, or his tactics or his

client's cooperation with the company or the government. As Judge Kaplan has noted, any such conditions would be disturbing. The boundary between a legitimate interest in competence and improperly influencing choice of counsel is, to be sure, a vague one. The choice must, nonetheless, be left to the individual. If the individual chooses competent counsel not proposed or preferred by the company, the company should accept the choice and pay the legal expenses pursuant to its policies.

Who is Covered

More than any other consideration, the scope of coverage within the company for individual, company-related legal expenses is peculiar to its business type and culture. For a company whose transactions are few but large and complex, coverage of all operative and management personnel may be warranted. Yet, where the company's operations consist of thousands or millions of small transactions, coverage of lower level employees may be both unduly expensive and unnecessary.

In Sum

Advance consideration of a policy for paying an individual's legal expenses can substantially enhance a company's flexibility and control when an internal or external matter raises a demand for payment. Periodic review is important to assure adjustment of the policy to developments in the company's operations and culture, as well as the government's changing regulatory and law enforcement practices. Thoughtful consideration of alternative conditions is necessary to tailor the policy most effectively to the company's needs and culture.

Stuart F. Pierson
Troutman Sanders, LLP
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