

White Collar Practice Alert

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*Second Circuit Rejects Ancillary Jurisdiction in
Fee Indemnification Claim Against KPMG**by Andrew Weissmann, Robert R. Stauffer & Thomas P. Monroe*

On May 23, 2007, the United States Court of Appeals for the Second Circuit wrote the latest chapter in a case arising out of the highly publicized criminal investigation of accounting firm KPMG, LLP ("KPMG") that resulted in charges against numerous former KPMG employees and others for allegedly promoting illegal tax shelters. *Stein v. KPMG, LLP*, ___ F.3d ___, 2007 WL 1487822 (2nd Cir. 2007); see also *United States v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006); *United States v. Stein*, 440 F. Supp. 2d 315 (S.D.N.Y. 2006).

Facing potential indictment, KPMG entered into a deferred prosecution agreement with the government. As part of its efforts to avoid indictment and, as found by the District Court, at the behest of the government prosecutors, KPMG capped the legal fees it would pay for counsel for its employees who were under investigation (collectively, the "Stein Defendants"). After being indicted, the Stein Defendants challenged KPMG's decision to cut off legal fees, arguing that the government caused KPMG to cut

off legal fees and thereby violated their Fifth and Sixth Amendment rights. Additionally, they claimed that pretrial statements made by the defendants to government investigators were involuntary and should be suppressed. In two ground-breaking rulings (which were the subject of prior client alerts, see District Court Rules the Government's Use of the Threat of Corporate Indictment was Unconstitutional and *United States v. Stein*), U.S. District Judge Lewis Kaplan agreed that the government had infringed on the Stein Defendants' constitutional rights and suppressed the statements of two defendants, but declined at that time to dismiss the indictment, finding that a lesser remedy might alleviate the need for such Draconian relief. Specifically, Judge Kaplan concluded that the Stein Defendants could sue KPMG under express or implied-in-fact contract theories and potentially recover their attorneys' fees.

In an attempt to resolve the tension between a potentially slow-moving civil lawsuit and the Stein Defendants' right to a

speedy trial, Judge Kaplan, on his own motion, ordered the clerk to open a civil case number and invited the Stein Defendants to file their civil complaint against KPMG. Judge Kaplan ruled that he could hear the Stein Defendants' claims against KPMG under the court's ancillary jurisdiction. Although federal courts are courts of limited jurisdiction that may hear only cases specifically authorized by the U.S. Constitution and Congress, an exception to this rule is that federal courts may, in limited cases, exercise ancillary jurisdiction over claims between parties if the court already has jurisdiction over another claim between the same parties.

Armed with Judge Kaplan's ruling, the Stein Defendants duly filed a civil complaint against KPMG. KPMG moved to dismiss the complaint, arguing: (i) that federal courts did not have jurisdiction over the Stein Defendants' claims against KPMG, even under ancillary jurisdiction; and (ii) if the court did have jurisdiction, the court should still dismiss the complaint and order the Stein Defendants to arbitrate their

claims against KPMG because the Stein Defendants had expressly agreed to arbitration. Judge Kaplan denied KPMG's motion, and KPMG appealed.

The Second Circuit held that Judge Kaplan's exercise of ancillary jurisdiction was improper, in large part because unlike most cases where ancillary jurisdiction is upheld, the Stein Defendants' claim was a civil one brought against a non-party to a criminal proceeding. The court found that as a non-party, KPMG would be prejudiced by having to litigate the Stein Defendants' claims because, among other things, it would be forced to litigate the claims on an expedited basis and outside the confines of the contractually negotiated arbitration. The Second Circuit also found that in addition to the prejudice to KPMG, there was little need for the exercise of ancillary jurisdiction, since the district court had other available remedies -- assuming, without deciding, the merits of the district court's constitutional holding. The Second Circuit, expressing "no opinion" on the issue of whether the government violated the Stein Defendants' constitutional rights, noted that if their rights were

violated, "[d]ismissal of an indictment ... is always an available remedy." *Stein*, ___ F.3d at ___, 2007 WL 1487822, at *7. Notably, in a pointed footnote, the Second Circuit expressed considerable skepticism that the Stein Defendants could prevail in their civil case for fees against KPMG, noting that the defendants may have waived the issue and that the defendants' "implied in fact" theory appeared to be negated by a lack of KPMG having a "history" of making such payments.

Although the Second Circuit's ruling resolved only the seemingly limited question of whether the district court had ancillary jurisdiction over certain civil claims brought by former KPMG employees against the accounting firm, the court's decision may have more far reaching ramifications on remand. The Second Circuit appeared to invite the district court to dismiss the indictment as a remedy for the alleged violation. Such an approach would allow the government to appeal immediately that decision to the Second Circuit to review the merits of the constitutional decision. There is considerable reason to believe that the circuit would reverse the

district court's Fifth and Sixth Amendment analysis by finding, among other things, the Stein Defendants were not prejudiced by the government coercion because they are still being vigorously represented by the counsel of their choice. *See, e.g., United States v. Rosen*, ___ F. Supp. 2d ___, No. 05 CR 225, 2007 WL 1390661, at *12 (E.D. Va. May 8, 2007) ("Given the mountain of evidence testifying to the vigor of the defense being mounted on behalf of these defendants, it is simply not tenable to argue that the loss of...fee payments has caused defense counsel to do less than their professional duty.") Knowing of this distinct risk, the ball is now firmly in Judge Kaplan's court to decide what remedy he will grant the Stein Defendants and whether he will invoke a remedy that will permit a government appeal of his ruling pretrial. The district court has set a July 2 hearing on the Stein Defendants' motion to dismiss the indictment or for other relief. What is clear now, however, is that the Second Circuit decision is a victory for KPMG and may well prove ultimately to be one for the government as well.

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