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13 UNITED STATES DISTRICT COURT
 14 CENTRAL DISTRICT OF CALIFORNIA
 15 WESTERN DIVISION

17 UNITED STATES OF AMERICA,
 18 Plaintiff,
 19 v.
 20 BRUCE KARATZ,
 21 Defendant.

Case No. CR No. 09-0203-ODW

**DEFENDANT BRUCE KARATZ'S
 MOTION FOR EVIDENTIARY
 HEARING REGARDING
 TESTIMONY OF CRUCIAL
 WITNESSES; MEMORANDUM OF
 POINTS AND AUTHORITIES IN
 SUPPORT THEREOF**

Date: February 8, 2010
 Time: 11:00 a.m.
 Courtroom: 11
 Judge: Hon. Otis D. Wright II

Pre-Trial Conf.: February 8, 2010
 Trial Date: February 23, 2010

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1 TO THE UNITED STATES OF AMERICA AND ITS COUNSEL OF
2 RECORD:

3 PLEASE TAKE NOTICE that at the time and place set forth above, or as
4 soon thereafter as the matter may be heard, Defendant Bruce Karatz will move the
5 Court to conduct a pre-trial evidentiary hearing in order to explore and question
6 witnesses under oath regarding the false denials made by James Johnson to the
7 government regarding his previous statements to Irell & Manella LLP lawyers,
8 which were exculpatory to Mr. Karatz, and his subsequent altered testimony in
9 favor of the government's case against Mr. Karatz.

10 Moreover, Mr. Karatz moves the Court to conduct a pre-trial evidentiary
11 hearing on the circumstances under which Gary Ray became a cooperating
12 government witness by pleading guilty to conduct which was not criminal, despite
13 consistently defending the lawfulness of the acts charged against Mr. Karatz.

14 This Motion is based on the attached Memorandum of Points and
15 Authorities, the attached Appendix, the Declaration of Benjamin Au in Support of
16 the Motion, the Request for Judicial Notice, the Declaration of Benjamin Au in
17 Support of the Request for Judicial Notice, all filed concurrently herewith, the files
18 and records in this case, and any argument or evidence offered at the hearing on
19 the Motion.

20
21 Dated: January 4, 2010

Respectfully submitted,

22 KEKER & VAN NEST LLP
23 CALDWELL LESLIE & PROCTOR, PC

24
25 By: /s/ John W. Keker
26 JOHN W. KEKER
27 Attorneys for Defendant BRUCE KARATZ
28

1 MEMORANDUM OF POINTS AND AUTHORITIES

2 I. INTRODUCTION

3 The evidence as it existed before the prosecution became involved shows
4 that the two people most responsible for stock options at KB Home—
5 Compensation Committee Chair James Johnson and Human Resources chief Gary
6 Ray—both firmly believed that the stock option grant practice was lawful, and they
7 were willing to say so. Once the prosecutors got ahold of them, that changed.
8 Other backdating cases in this District and this Circuit show that the government’s
9 efforts to silence, recast or outright misrepresent the state of mind of potential
10 witnesses for the defense can critically affect whether the defendant gets a fair
11 trial. Mr. Karatz therefore requests an evidentiary hearing with respect to the
12 government’s conduct toward Messrs. Johnson and Ray, two important witnesses
13 whose testimony appears to have recently evolved from favorable to the defense to
14 favorable to the government.

15 In the recent trial of *United States v. Ruehle*, No. CR 08-00139-CJC, before
16 Judge Carney, the government first silenced potential defense witnesses with
17 threats of prosecution, and then after Judge Carney granted a motion for defense
18 witness immunity, it threatened a witness with prosecution unless he testified a
19 certain way. In throwing out the case where the government had “intimidated and
20 improperly influenced the [] witnesses critical to [the] defense,” Judge Carney
21 found that the “cumulative effect of that misconduct ha[d] distorted the truth-
22 finding process and compromised the integrity of the trial.” *See* Declaration of
23 Benjamin Au in Support of Request for Judicial Notice (“Au Decl. RJN”) ¶ 2, Exh.
24 A (12/15/09 Transcript of Proceedings in *United States v. Ruehle*, Request for
25 Judicial Notice) at 5195:7-10. In *United States v. Reyes*, 577 F.3d 1069 (9th Cir.
26 2009), the Ninth Circuit held in 2009 that the prosecutors had committed
27 misconduct in their closing statement by arguing that certain absent witnesses from
28 the Company’s (Brocade) finance department would testify a certain way, when

1 the government knew they would not. *Id.* at 1077. Strikingly similar issues appear
2 to be arising in this case.

3 James Johnson was the former Chair of the Compensation Committee of the
4 KB Home Board of Directors. He also served on the Compensation Committee of
5 United Healthcare, a company with significant stock option issues, and was the
6 Chief Executive Officer of Fannie Mae. On September 12, 2006, Mr. Johnson was
7 interviewed by Irell & Manella LLP (“Irell”), outside counsel for the KB Home
8 Board of Directors’ independent investigation relating to stock options. A memo
9 summarizing Mr. Johnson’s interview with Irell was prepared at the time. Mr.
10 Johnson’s statements were extremely helpful to Mr. Karatz and consistent with Mr.
11 Karatz’s anticipated defense at trial. He told Irell at least eight separate times that
12 it was commonly understood that the Compensation Committee had delegated to
13 management, even if informally, the authority to pick the grant date and exercise
14 price for options. He defended the option grant process at KB Home and stated
15 that he had no expectation as to what the grant date for options should be. Based
16 on those statements, Mr. Johnson was a strong defense witness.

17 Of course, these statements placed Mr. Johnson closer to the stock option
18 practices at KB Home that had gotten Mr. Karatz indicted, and it is not hard to
19 imagine a prosecutor pointing out to Mr. Johnson the risks of so testifying at trial.
20 Thereafter, on July 10, 2008, nearly two years after his interview with Irell, Mr.
21 Johnson was interviewed by the prosecutors in this case and members of the FBI.
22 During that interview, Mr. Johnson denied having made the statements attributed
23 to him by Irell and instead gave a markedly different account of the events—one
24 far more consistent with the government’s theory in its Indictment—and although
25 tortured, far less exculpatory of Mr. Karatz. Only recently did Mr. Karatz receive
26 from Irell the actual notes taken by Irell during Mr. Johnson’s interview. These
27 notes are extremely detailed and are in question-and-answer format, reading almost
28 like a transcript. They confirm that Mr. Johnson made the lengthy, exculpatory

1 statements attributed to him by Irell.

2 How and why Mr. Johnson made two such distinct sets of statements, going
3 so far as to falsely deny having made the first set, is an issue of the utmost
4 importance, which implicates Mr. Karatz's due process right to a fair trial. Having
5 made exculpatory statements to Irell, and then having (falsely) denied making such
6 statements during an interview with the government, raises very troubling
7 inferences about Mr. Johnson's testimony and its manipulation, questions that can
8 only be addressed via a pre-trial hearing in which Mr. Johnson, the Irell lawyers
9 who interviewed him, and the FBI agent who conducted the government interview
10 testify under oath.

11 Gary Ray was the Vice President of Human Resources at KB Home, and the
12 executive most directly responsible for option practices at the Company. Mr. Ray
13 has told the government that during the critical years in question—1999 through
14 2005—he believed that the way in which options were granted at KB Home was
15 entirely lawful and proper. However, Mr. Ray also has stated that commencing in
16 about May 2006, he misled the Company's general counsel who was conducting an
17 investigation into the Company's historical stock option grant practices. In 2008,
18 as the pressure on Mr. Ray mounted in advance of an indictment, he eventually
19 entered into a plea and cooperation agreement with the government pursuant to
20 which Mr. Ray pleaded guilty to one count of obstruction of justice for having
21 misled the general counsel.

22 These circumstances are highly suspicious and unusual, in that it appears
23 that the conduct to which Mr. Ray pleaded guilty does not constitute a crime under
24 applicable federal law. This is troubling in light of Judge Carney's recent finding
25 in *United States v. Samuelli*, No. CR 08-00156-CJC, that an executive had been
26 bullied into pleading guilty to a crime that he did not commit, as well as his finding
27 in *United States v. Ruehle* that Nancy Tullos, the government's key cooperating
28 witness and also an HR executive like Mr. Ray, had been badgered and harassed

1 into furnishing false testimony in exchange for promises of leniency pursuant to a
2 bogus plea agreement. In order to safeguard Mr. Karatz's due process right to a
3 fair trial, the Court should also conduct a pre-trial hearing regarding Mr. Ray, in
4 which he testifies and the Court is given the opportunity to evaluate the suspect
5 circumstances surrounding his guilty plea.

6 Given the elusive, but crucial, issue of intent that presents itself in each of
7 these backdating cases, and the potency of government threats to executives who
8 could testify in a way that would help a defendant, it is crucial that the Court hold a
9 hearing into (a) the inexplicable, dramatic, and false denials by Mr. Johnson about
10 having previously made powerful exculpatory statements; and (b) the
11 circumstances under which Mr. Ray became a government cooperator by pleading
12 guilty to conduct which was not criminal.

13 II. FACTS

14 A. **James Johnson falsely denies to the government that he made** 15 **statements to Irell in defense of Bruce Karatz and KB Home's stock** **option grant process.**

16 Mr. Johnson served as Chair of KB Home's Compensation Committee from
17 1995 until 2000 and remained as a member from 2004 to 2008. Irell interviewed
18 him on September 12, 2006 on behalf of the Board of Director's independent
19 investigation relating to stock options. Mr. Johnson's responses were critical
20 because, as a long-time member and former chair of the Committee, he could
21 speak to whether the Company's stock option grant practice was transparent,
22 whether the Committee was aware and approved of management selecting the
23 grant dates, and whether this practice was believed to be lawful at the time.

24 According to the memo prepared by Irell the day after the interview (the
25 "Irell Memo"), which was based on the detailed notes taken during that interview,
26 Mr. Johnson:

27 would concede there was a delegation of authority to set the grant date
28 and price, but said that it was never discussed as a 'delegation,'
although it was clearly within management's assigned duties to make

1 the determination.

2

3 Johnson explained that if the assignment of a date had not been
4 delegated, since everyone knew about it, somebody would have
5 questioned the practice. Johnson felt that there was no one taking
6 advantage of the system or being nefarious and that the pattern of
7 behavior persisting over the period validated the delegation.

8

9 Johnson added that there was no discussion regarding delegating to
10 management the power to set their own option price, but that it was
11 clear practice, conducted in the open and which the Committee was
12 aware of.

13 Declaration of Benjamin Au in Support of Motion for Evidentiary Hearing
14 Regarding Testimony of Crucial Witnesses (“Au Decl.”) ¶ 2, Exh. A (Irell
15 Interview Memo for James Johnson dated September 13, 2006) at 2; 5; 6.

16 Once the government got ahold of Mr. Johnson, however, his testimony
17 tacked sharply in the opposite direction. According to the government’s Federal
18 Bureau of Investigation Form FD-302 of its interview on July 10, 2008, the
19 government specifically asked Mr. Johnson whether there had been a delegation of
20 authority to management to set the grant date. While Mr. Johnson first stated that
21 “the stock option award process had evolved over time such that it might have
22 been implied that there was delegation,” he said that Irell had not accurately
23 characterized what he had told them. Au Decl. ¶ 3, Exh. B (James Johnson Form
24 302 dated July 11, 2008) at 1. Suspiciously, however, as the course of the
25 government’s interview wore on, Mr. Johnson’s denials of the delegation issue
26 became more firm, and his memory of what he told Irell more dim. Mr. Johnson
27 said that he did not recall telling Irell that everyone knew about the delegation or
28 that it was validated by the fact that no one questioned it. *Id.* at 4. He told the
government unequivocally that “[he] never agreed with the concept that the
selection of a grant date was delegated to management,” and that “the
Compensation Committee was not aware to his knowledge that management was

1 picking the strike price.” *Id.* at 4-5.

2 Counsel for Mr. Karatz recently obtained the notes taken by the Irell lawyers
3 interviewing Mr. Johnson (the “Irell Notes”), which served as the basis for the Irell
4 Memo. These notes were contemporaneously taken at the time of the interview,
5 and are drafted in transcript format, identifying the questions posed by Irell and the
6 responses given by Mr. Johnson. The Irell Notes confirm in stark detail that the
7 Irell Memo’s account of Mr. Johnson’s statements were taken almost verbatim
8 from Mr. Johnson’s own words.

9 Q: Under the circumstance you are describing, you are delegating to
10 management the authority to set the grant date, and thus the price?

11 A: Yes, it was never discussed as a delegation, but it was clearly
12 within management’s assigned duties to do that.

13 Au Decl. ¶ 4, Exh. C (Irell Contemporaneous Notes of Interview with James
14 Johnson dated September 12, 2006) at 4.

15 Q: [S]ome people might read this as an actual discussion [about
16 delegation] between management and the committee. We haven’t
17 seen anything like this before.

18 A: This is tortured, but if it weren’t delegated, and every[one] knew
19 about it, if there was [sic] some reservations about [it], somebody
20 would have questioned it. It seems to me that you can’t have a
21 practice of behavior that persists if it had not been delegated. This
22 was not a one-off nefarious taking advantage of the system.

23 *Id.* at 12.

24 Similarly, according to the Irell Memo, Mr. Johnson said that

25 [H]e thought management’s involvement in setting the grant date was
26 better described as a practice, and that it had gone on for years and
27 that informed individuals had their eyes open to it, and no one had
28 ever suggested there might be tax, accounting, other issues
surrounding the behavior.

29 Au Decl., Exh. A at 4. But when interviewed by the government, Mr. Johnson
30 again totally disclaimed his prior position. He told the government that Irell had
31 “overstated” it, and that, inter alia:

32 He had no reason to believe that the other Compensation Committee
33 members believed that management was picking the grant date and
34 Johnson did not hold this view either because the specific topic of

1 management picking the grant date was not discussed in the
2 Compensation Committee meetings.

3

4 Executive management's only responsibility was to complete the
5 allocation process, not to set the strike price of the stock options.
6 Executive management did not have the authority to pick the stock
7 option price, and the Compensation Committee did not approve or
8 ratify this practice.

9 Au Decl., Exh. B at 2. But the Irell Notes, once again, confirm that Mr. Johnson's
10 denials to the government were false. He did in fact tell Irell that management's
11 involvement in setting the grant date was common knowledge. Again, the Irell
12 Memo quotes near verbatim the response Mr. Johnson gave during his interview
13 with them.

14 Q: Would the Comp. Committee, under the delegation—

15 A: I don't know if I'd call it delegation. It was the practice. And
16 everybody's eyes were open, and it was the practice and it went on for
17 years. Informed individuals were present, and everybody knew about
18 the practice, and continued to occur without the benefit of anyone
19 saying there might be tax problems, accounting problems, other
20 problems.

21 Au Decl., Exh. C at 10.

22 During his interview with Irell, Mr. Johnson also discussed the issue of the
23 grant date for stock options. According to the Irell Memo:

24 Johnson indicated that he had no expectation at the time regarding
25 when the stock option grant date would be set, and it was not until the
26 past couple months that he learned about the various possible dates.
27 He did not recall whether Committee meetings corresponded to the
28 grant dates, or whether perhaps other meetings corresponded to the
29 dates, and review of the documents didn't refresh his recollection.

30 Au Decl., Exh. A at 7. But when he spoke to the government, he said that he did in
31 fact have an expectation as to the grant date. The government's Form 302 states
32 that:

33 Johnson assumed dates were set as of the Compensation Committee
34 meeting date Johnson did not know that the date used to determine
35 the stock option strike price was different from the date of the stock
36 price on the day of the Compensation Committee meeting.

37

1 The Compensation Committee members knew that additional grants
2 needed to be made to the rank-and-file, therefore the Compensation
3 Committee members knew that there was further work to be done by
4 executive management. However, everyone in the Compensation
5 Committee meeting did not know that part of the unfinished business
6 that executive management needed to do was to choose a strike price
7 that was different from the Compensation Committee meeting date.

8 Au Decl., Exh. B at 1-2.

9 The Irell Notes again tell a different story, one that is totally consistent with
10 the Irell Memo but stands in stark contrast with what Mr. Johnson later told the
11 government:

12 Q: As a result of this practice we've been describing, what was your
13 expectation as to what the grant date was going to be?

14 A: I did not have an expectation. Sixty days ago, I learned about the
15 various dates. I didn't recall whether we had Comp. Committee
16 meetings as the date, or some other meeting as the date.

17 Au Decl., Exh. C at 14.

18 As yet another example, according to the Irell Memo, Johnson was asked a
19 series of questions regarding his thoughts on Mr. Karatz's involvement in setting
20 the grant date and exercise price:

21 Johnson had no recollection of Karatz setting the grant date. When
22 asked, hypothetically, whether it would disturb him to learn Karatz, as
23 opposed to management, was picking the exercise price of his own
24 options, Johnson said he did not think it would have disturbed him in
25 the time before Sarbanes-Oxley and all the recent attention to
26 management impropriety. He gathered from the recent literature that
27 hundreds of companies had options practices similar to KBH (he
28 noted that his own company did not, although one of the other
companies on whose board he sat did). He said that had he learned
Karatz was going to pick the best price over a 3 month period, he
might or might not have had a problem; regardless it was entirely
hypothetical, as the issue was never raised in Committee meetings, or
by management, at any time.

.....

Johnson was unsure how he would have responded if, hypothetically,
he had learned that management's practice was to backdate stock
options.

Au Decl., Exh. A at 3-4. When the government brought this to Mr. Johnson's
attention, he said that he "did not recall making those statements and such

1 statements did not sound like something [he] would have said.” *Id.* at 3. Further,
2 according to the Form 302:

3 Johnson said if he had learned that Karatz was backdating stock
4 options, [he] would have considered the action totally inappropriate at
5 the time. However, Johnson would not have known if such action was
6 impermissible. Johnson would have thought such actions were a bad
7 practice . . . he would have brought it to the attention of the other
8 Compensation Committee members and he would have recommended
9 that a fixed date be used for all future annual stock option grants.

10 Au Decl., Exh. B at 3. With regard to his statement about how he would have
11 responded if he had learned that management had been backdating, Mr. Johnson
12 lambasted Irell, telling the government that he “felt that Irell’s investigators were
13 trying to force [him] to make a statement that they wanted to hear . . . [he] felt
14 irritated during his interview with Irell because he felt they were disorganized and
15 they did not fully understand what they were investigating.” He told the
16 government that “his answers during the Irell interview were slanted against the
17 negative implications Irell appeared to want him to draw” *Id.* at 3.

18 But the Irell Notes tell a different story. In fact, Mr. Johnson’s own words,
19 as set forth in the Irell Notes, demonstrate even more clearly than the Irell Memo
20 that Mr. Johnson firmly believed the process at KB Home was proper. Moreover,
21 there is no indication that Irell put any pressure on Mr. Johnson to force him to
22 answer their questions in any particular way. To the contrary, the Irell Notes show
23 that Mr. Johnson’s responses were thoughtfully and freely given.

24 Q: Suppose you learned that instead of management, it was Bruce
25 Karatz that was picking the exercise price, of his own options?
26 Would that disturb you?

27 A: I don’t think so. Maybe today, with SOX, and all this
28 management impropriety. I gather from reading the literature that at
hundreds of companies today, they had practices somewhat similar to
this. We did not have this at my company, but one of the other
companies, on whose board I sat, had a similar procedure. If someone
had said Bruce is going to sit around for three months and pick the
best price, I might have had a problem, maybe I might not. Today I
would. But this is certainly hypothetical, this was never raised in
Committee meetings, by management, at anytime or any point.

....

1 Q: So even if you had known that backdating was going on, you
2 wouldn't have known it was a problem?

3 A: The people on this Board were extremely financially
4 sophisticated. If somebody had said, there might be an accounting
5 issue, a credibility issue, we would have investigated it.

6 Even though a number of us came out of companies, well, my
7 company went on a fixed date, some companies had different date-
8 setting mechanisms. I mean, some of the look-backs in these cases
9 were much longer periods—here, it was very constrained.

10 I can assure you that there were no discussions between the
11 Committee and counsel, accountants, over the propriety of the
12 practice. Had this happened, everybody would have pulled up their
13 chair, and said 'let's get to the bottom of this.'

14 Au Decl., Exh. C at 6; 10.

15 Similarly, Mr. Johnson told Irell that the idea that Mr. Karatz's involvement
16 in trying to pick "the best price" would "not have been a problem." The Irell
17 Memo states that:

18 Johnson felt that the landscape has changed, and that at the time, the
19 idea that management, or Karatz, would be involved in trying to pick
20 the best price, would not have been a problem. Had the Company
21 said, 'we are going to pick some date between September and
22 December for this grant,' it would not have been a problem. He
23 reiterated that this did not happen, nor was it the practice at his own
24 company to have a flexible grant date.

25 Au Decl., Exh. A at 6. The government asked Mr. Johnson about this specific
26 statement. As an initial matter, Mr. Johnson told the government that he did not
27 recall saying this to Irell. Further, he said that:

28 [a]t the time, [he thought] establishing a grant date was a different
concept than choosing a strike price just to obtain a low price point.
At the time, Johnson would have considered it permissible for
administrative reasons to go back, for example to the beginning of a
quarter, but not to pick a stock option strike price looking back just to
lock in a lower price.

....

The shopping of stock option dates would have been beyond anything
that Johnson would have imagined.

Au Decl., Exh. B at 5; 1-2. Again, the Irell Notes, however, prove that the Irell
Memo accurately captured Mr. Johnson's statements—the same statements he later

1 could not recall when speaking with the government:

2 Q: It makes sense to me that the committee [is] not going to be
3 involved in every allocation to every employee. Do you recall any
4 discussion at any time, about delegating to management authority to
5 price options?

6 A: No, I don't. On the other hand, it became the practice. The
7 committee was apparently aware of it. Obviously it wasn't hidden
8 from the committee. But no, I don't recall discussion.

9 I guess what I'm trying to say is that the landscape has changed. That
10 management, that Bruce would be involved in trying to pick the best
11 price, at the time, was not a problem.

12 My company practice was different, but on its face this was not an
13 issue. If they had said, we're going to pick some date between
14 September and December, for this grant, it would not have been an
15 issue. I don't recall that, though.

16 Au Decl., Exh. C at 7.

17 **B. Gary Ray pleads guilty to one count of obstruction of justice under
18 mounting pressure after having defended to the government KB
19 Home's stock option grant process.**

20 After years of maintaining his innocence, Gary Ray is now cooperating with
21 the government and is expected to be called at trial on its behalf. The government
22 had threatened Mr. Ray with a long, drawn-out prosecution for some of the same
23 crimes charged against Mr. Karatz. He also faced the prospect of a lengthy prison
24 sentence—the maximum allowable under the Sentencing Guidelines, which the
25 government told him it intended to seek if convicted. Due to his family
26 circumstances, however, Mr. Ray believed that prison time was not an option. His
27 wife was sick and he had two children for whom he was responsible. *See, e.g.*, Au
28 Decl. ¶ 5, Exh. D (Connie Fox Form 302 dated June 18, 2008) at 3. Under this
mounting pressure, Mr. Ray pleaded guilty to one count of conspiracy to obstruct
justice pursuant to 18 U.S.C. sections 371 and 1519 on December 15, 2008.

The government chose to charge Mr. Ray under a relatively new, untested
statute. Section 1519, entitled “Destruction, alteration, or falsification of records in
Federal investigation and bankruptcy” was enacted with the passage of the
Sarbanes-Oxley Act, and is primarily regarded as an anti-document destruction

1 provision. There is no allegation that Mr. Ray destroyed any documents. Instead,
2 according to the Information charging Mr. Ray and the government's recitation at
3 the plea allocution hearing, he conspired to "cause[] a false record or document to
4 be created," and to "impede, obstruct or influence a contemplated investigation of
5 the Securities and Exchange Commission [SEC]." Au Decl. RJN ¶ 3, Exh. B
6 (2/9/09 Transcript of Gary Ray Plea Allocution Hearing) at 32:21-22; 11:22-24.

7 The alleged "false record or document" that Mr. Ray conspired to "cause"
8 was the report on the Company's stock option grant process drafted by the general
9 counsel following his internal investigation. See Au Decl. RJN ¶ 4, Exh. C
10 (Information in *United States v. Ray*) ¶ 10. According to the government, had its
11 case against Mr. Ray gone to trial, it would have proven beyond a reasonable doubt
12 that "beginning as early as mid-March 2006, and ending on or about mid-August
13 2006, there was an agreement between two or more persons"—*i.e.*, Messrs. Ray
14 and Karatz—"to impede, obstruct or influence a contemplated investigation of the
15 [SEC] in violation of [] section 1519." Au Decl. RJN, Exh. B at 11:20-25. Yet,
16 Mr. Ray told the government that "he believed it was okay to lie to Hirst [KB
17 Home's general counsel] because it was only an internal investigation." Au Decl.,
18 Exh. E ¶ 6 (Gary Ray Form 302 dated 10/7/08) at 4. There is simply no evidence
19 that any SEC investigation into KB Home was contemplated at the time that Mr.
20 Ray spoke to the general counsel.

21 As discussed *infra*, however, the government negotiated a plea agreement in
22 which Mr. Ray pleaded guilty to conduct that was not criminal, and became a
23 government cooperating witness in exchange. And while he pleaded guilty to his
24 acts in 2006 during the general counsel's investigation, he staunchly maintained
25 both before and after the plea agreement that KB Home's stock option grant
26 practice had always been considered to be lawful and proper. For example, even in
27 the weeks leading up to the plea agreement, Mr. Ray told the government that he
28 "hadn't seen anything wrong with the pre-SOX" process, and that "[n]o alarm bells

1 were triggered for [him] concerning KB’s option dating practices until 2006” when
2 the media frenzy on backdating at other companies began. Au Decl. ¶ 7, Exh. F
3 (Gary Ray Form 302 dated 10/24/08) at 4-5.

4 Mr. Ray maintained repeatedly that the practice was transparent, stating that
5 he “always believed they had a transparent process, because of the dynamic of
6 KB’s working environment.” *Id.* “[H]e didn’t believe it was a secret how they
7 picked the grant date. KB wasn’t a formal environment and since [he] wasn’t
8 hiding anything, he figured that everyone knew.” Au Decl., Exh. E at 6. In fact,
9 Mr. Ray told the government that he liked the grant practice because he “felt that
10 choosing a low stock price was a good booster to employee morale[.]” Au Decl. ¶
11 8, Exh. G (Gary Ray Form 302 dated 11/4/08) at 4. And these assertions of
12 innocence are consistent with Mr. Ray’s own notes written in mid-2006—before
13 he decided to plead guilty—in which he vigorously defended the stock option grant
14 practice and confirmed that management had always believed the practice to be
15 lawful. *See* Au Decl. ¶ 9, Exh. H (Gary Ray Handwritten Notes) at 1. *Accord id.* ¶
16 10, Exh. I (Gary Ray Handwritten Notes on Memorandum Prepared by KB Home
17 Counsel Munger, Tolles & Olson LLP dated June 26, 2006).

18 Mr. Ray fundamentally challenged the government’s theory that he and
19 Mr. Karatz selected the grant date and exercise price with criminal intent. He told
20 the government that his “idea of backdating was dating options before the date that
21 the Compensation Committee met”—a practice that never happened at KB Home.
22 *See* Au Decl., Exh. F at 1. He even told KB Home’s general counsel during the
23 internal investigation that “the grant date was the day they picked,” *id.* at 2, and
24 that even following the Sarbanes-Oxley Act, he “was still of the belief that the
25 grant date was the date selected for the grant date. It was okay because they used
26 the market price on the day that was picked.” Au Decl., Exh. F at 4.

27 Consistent with the evidence, Mr. Ray has maintained to the government
28 that everyone involved in KB Home’s stock option grant process, including

1 himself and Mr. Karatz, believed that it was lawful. Despite that, the prosecutors
2 effectively flipped Mr. Ray, capitalizing on threats of a lengthy prison term, and he
3 is now expected to give testimony favorable to the government pursuant to the
4 terms of his cooperation agreement.

5 III. ARGUMENT

6 A. **Bruce Karatz's inability to call James Johnson and Gary Ray as 7 witnesses on his behalf hampers his ability to put on a defense.**

8 James Johnson and Gary Ray are among the two most crucial witnesses in
9 this case. As Chair and, later, member of KB Home's Compensation Committee,
10 Mr. Johnson was responsible for leading the Company in approving and funding
11 stock option awards for employees, and setting compensation policy. And as the
12 head of Human Resources, Gary Ray administered that compensation policy on a
13 companywide basis. They previously made powerful exculpatory statements on
14 behalf of Mr. Karatz and in defense of the stock option grant process—the process
15 for which they were both personally responsible. Presently, however, Mr. Johnson
16 can no longer be called as a defense witness after having dramatically flipped his
17 testimony in favor of the government despite earlier statements in favor of Mr.
18 Karatz's defense, and going so far as to deny having made those earlier statements.
19 Mr. Ray has also been effectively flipped, after negotiating a cooperation plea
20 agreement with the government for conduct that was not even criminal.

21 These circumstances raise a strong inference of potential government
22 misconduct, and hamper Mr. Karatz's ability to present a defense. The Supreme
23 Court has made clear that:

24 [t]he right to offer the testimony of witnesses, and to compel their
25 attendance, if necessary, is in plain terms the right to present a
26 defense, the right to present the defendant's version of the facts as
27 well as the prosecution's to the jury so it may decide where the truth
28 lies . . . This right is a fundamental element of due process of law.

Washington v. Texas, 388 U.S. 14, 19 (1967). *Accord United States v. Black*, 767
F.2d 1334, 1337 (9th Cir. 1985) (“[T]he government may not interfere with

1 defense access to witnesses.”). Judge Carney recognized the significance of this
2 right when he ordered an evidentiary hearing upon finding a strong inference that
3 the government had picked off potential defense witnesses, one-by-one, with
4 threats, intimidation, and bogus plea agreements in exchange for cooperation. He
5 found that, for the defendant’s due process rights to have any meaning, “the
6 government must not do anything to intimidate or improperly influence witnesses.”
7 *Au Decl. RJN, Exh. A at 5195:15-17.*

8 And it was only after conducting the evidentiary hearing could Judge Carney
9 plainly state, “I now know the entire story of what happened.” *Id.* at 5195:2-3.
10 Judge Carney recognized that because, as here, the defendants’ criminal intent was
11 the central issue before the jury, “it was imperative . . . to call the [] available
12 witnesses who had knowledge of [the company’s] stock-option granting practices.”
13 *Id.* at 5195:19-23. He found that the government had rendered those witnesses
14 unavailable for the defense by harassing one—Nancy Tullos—and coercing her
15 into entering into an “unusual” plea agreement with a “questionable factual basis;”
16 keeping one—David Dull—“hanging in the wind” and uncertain of whether the
17 government would charge him; and bullying the third—Henry Samueli—into
18 pleading guilty to a crime he did not commit. *Id.* at 5196:3-5199:4. Mr. Karatz
19 moves for an evidentiary hearing so that the “entire story of what happened” with
20 respect to Mr. Johnson’s dramatic reversal of testimony and denial of prior
21 statements, and Mr. Ray’s unusual cooperation plea agreement can come to light.

22 In the face of suspicious circumstances raising an inference of possible
23 prosecutorial misconduct, the Court has the authority to order an evidentiary
24 hearing pursuant to its supervisory powers. The Ninth Circuit has recognized
25 expressly that the “exercise of supervisory powers is an appropriate means of
26 policing ethical misconduct by prosecutors.” *United States v. Lopez*, 4 F.3d 1455,
27 1463 (9th Cir. 1993). Moreover, the Court has the authority “to raise sua sponte
28 matters that may affect the rights of criminal defendants.” *United States v.*

1 *Delgado-Cardenas*, 974 F.2d 123, 126 (9th Cir. 1992). Pursuant to that
2 supervisory power, “[i]f, in fact, a material issue of fact were raised ‘which if
3 resolved in accordance with (appellant’s) contentions would entitle him to relief,’
4 an evidentiary hearing would be required.” *United States v. Irwin*, 612 F.2d 1182,
5 1187 (9th Cir. 1980) (quoting *Wright v. Dickinson*, 336 F.2d 878, 881 (9th Cir.
6 1964)). The factual allegations set forth as the basis for the need for the hearing
7 must be assumed as true. *See id.* Applying this standard to the facts described
8 above and in the attached exhibits, the exercise of the Court’s supervisory powers
9 is justified.

10 Mr. Johnson’s statements to Irell, memorialized in the Irell Memo and
11 captured in stark detail by the Irell Notes, comport with key elements of
12 Mr. Karatz’s defense. Those statements establish that Mr. Karatz’s charged acts
13 were approved, at least de facto, by the Compensation Committee. Mr. Johnson
14 stated that, even as Chair of the Committee, he had *no* expectation as to what the
15 grant date for options should be, and he was confident in the administrative process
16 management used to select that date. Further, by telling Irell that he would not be
17 concerned if the grant date was selected simply on the basis that it had the best
18 price, Mr. Johnson fundamentally challenged the premise of the government’s case
19 against Mr. Karatz. If even the Compensation Committee’s Chair did not have a
20 problem with looking back to pick a grant date based on the best price, then the
21 government’s case falls apart. Further, Mr. Johnson made clear to Irell that
22 everyone involved in the grant practice was aware that management was selecting
23 the date and believed the process to be appropriate, and the Company relied on
24 experts to ensure that their belief was accurate.

25 Mr. Johnson’s statements challenge head-on the government’s theory that
26 Mr. Karatz nefariously concealed the grant practice from the Compensation
27 Committee. In fact, his statements to Irell make out a scenario in which the
28 Committee is actually complicit in the conduct the government now views as

1 criminal. It is reasonable to infer that the government made Mr. Johnson aware of
2 the dangerous implications of these statements. Recognizing those dangers,
3 Mr. Johnson gave the government a different version of events—one that fit with
4 the government’s theory of the case, disassociating both himself and the
5 Compensation Committee from knowledge of anything management did with
6 respect to options. Mr. Johnson also denied knowledge or recollection of his own
7 statements to Irell, reflecting his need to insulate himself even further. But we now
8 know that those denials were false. And despite knowing about these dramatic
9 changes in Mr. Johnson’s testimony, the government still put him before the grand
10 jury and elicited the version of events suspiciously favorable to the government so
11 that it could get an indictment returned.

12 How and why Mr. Johnson made exculpatory statements in favor of Mr.
13 Karatz to Irell on crucial issues that will be tried in this case, then falsely denied
14 that he made such statements when speaking to the government, and then provided
15 diametrically-opposed testimony in favor of the government raises troubling
16 inferences that can only be uncovered in an evidentiary hearing.

17 Additionally, Mr. Ray’s current posture as a government witness after years
18 of maintaining his innocence and defending to the government the options grant
19 process at the Company must also be explored at a hearing. Mr. Ray’s anticipated
20 testimony on the grant process will be among the most crucial in this case. He was
21 intimately involved in virtually every aspect of grant allocation, pricing, and
22 administration. Before the government got ahold of Mr. Ray, he would have
23 testified that he, Mr. Karatz, and everyone involved in the grant process at KB
24 Home believed it to be lawful, and had no intent to use the process as a means to
25 defraud for their benefit. Mr. Ray stands before the Court today, however, as a
26 felon, having negotiated a plea agreement for a non-existent crime to protect
27 himself from prison.

28 Under binding Supreme Court precedent, however, Mr. Ray’s charged

1 conduct was not criminal. In *United States v. Aguilar*, 515 U.S. 593 (1995), the
2 Supreme Court held there must be a “nexus” in “time, causation, or logic” between
3 the allegedly obstructive act and the aim of the obstruction. *Id.* at 599. In *Aguilar*,
4 the Supreme Court rejected as “speculative” the government’s theory that a
5 defendant is guilty of obstructing a pending grand jury proceeding where he made
6 false statements to an investigating agent “who might or might not testify before
7 [that] grand jury.” *Id.* at 600-01. The Supreme Court strengthened this nexus
8 requirement and extended *Aguilar* in *Arthur Andersen LLP v. United States*, 544
9 U.S. 696 (2005). It held that jury instructions were “critically flawed” where they
10 “led the jury to believe that it did not have to find *any* nexus between the
11 persua[sion] to destroy documents [under 18 U.S.C. § 1512(b)] and any particular
12 proceeding.” *Id.* at 707. In doing so, the *Arthur Andersen* Court made clear that
13 even broad statutory language does not leave room for the government to argue
14 that a proceeding “need not even be foreseen.” *Id.* at 707-08. *See also United*
15 *States v. Dunn*, 434 F. Supp. 2d 1203, 1207 n.2 (M.D. Ala. 2006) (noting that an
16 “official proceeding” under section 1512(b) is not foreseeable just because it is
17 possible).

18 Here, there was no “contemplated” investigation by the SEC into stock
19 option grant issues at the Company at the time of Mr. Ray’s allegedly obstructive
20 acts, let alone the requisite nexus to such an investigation. In fact, the government
21 even acknowledged as much when it accepted his plea, using language to
22 demonstrate just how attenuated the purported connection between any future,
23 possible SEC investigation and Mr. Ray’s acts was: “The CEO and Ray both
24 agreed that *if this internal* investigation was not controlled, it *could evolve* into an
25 independent investigation that *could possibly lead to, among other things*, an SEC
26 investigation, a consequence that had been publicly reported at a number of
27 companies.” Au Decl. RJN, Exh. B at 29:23-30:2 (emphasis added). Nowhere
28 does the government state that at the time Mr. Ray allegedly made false statements

1 to the Company's general counsel, the SEC contemplated an investigation into KB
2 Home's grant practice. The investigation at KB Home was purely internal during
3 the time period charged in the Information.

4 Although it is not completely clear why Mr. Ray pleaded guilty, the strong
5 inference is that it allowed him to avoid the possibility of a drawn-out criminal
6 prosecution—which the government threatened—during a time of dire personal
7 circumstances, including an ill spouse. Pleading guilty to the charged crime also
8 meant that Mr. Ray would likely not have to serve any prison time nor pay
9 restitution, thereby keeping the substantial wealth that he had acquired in the form
10 of KB Home stock options. For the government, the charge and the subsequent
11 plea agreement, though invalid, secured Mr. Ray's cooperation and testimony
12 against Mr. Karatz. Moreover, the plea agreement made Mr. Ray a felon. In doing
13 so, the prosecutors operated under the same reasoning as their colleagues
14 prosecuting *Ruehle*. In Judge Carney's words, the government prefers for its star
15 witness to plead to a felony because "it look[s] more convincing to a jury." Au
16 Decl. RJN, Exh. A at 5196:15-16.

17 **B. Only a pre-trial evidentiary hearing will allow the Court and defense**
18 **counsel to uncover the true circumstances under which James Johnson**
and Gary Ray became government witnesses.

19 An evidentiary hearing backed by the Court's subpoena power is the only
20 remedy that can uncover the true circumstances surrounding Mr. Johnson's false
21 denials of prior statements and dramatic change in testimony, and Mr. Ray's
22 unusual guilty plea. We expect that the government may argue, for example, that
23 defense counsel is free to cross-examine Mr. Johnson at trial and seek to impeach
24 him with his statements to Irell. That argument misses the point. Mr. Karatz's
25 interest is not to discredit Mr. Johnson by impeaching him; his fundamental
26 interest is for Mr. Johnson to tell the truth. If the government has caused
27 Mr. Johnson to fear telling the truth—as he freely told Irell—then Mr. Karatz's
28 right to call witnesses in his defense has already been deprived. Similarly, if the

1 government caused Mr. Ray to bargain away the truth in exchange for leniency
2 pursuant to his plea agreement, Mr. Karatz's rights have been compromised.

3 In *Ruehle*, Judge Carney found that the government's misconduct toward
4 Nancy Tullos was neither erased nor remedied by the defendants' ability to cross-
5 examine her at trial. Her testimony had already been irreparably "tainted" by the
6 government's manipulation. *Id.* at 5199:16. In fact, the defense had the
7 opportunity to cross-examine all of the witnesses who had been manipulated by the
8 government, yet Judge Carney still threw out the indictments on the sole ground
9 that the defendants had been denied their right to call these witnesses on their own
10 behalf. Whether that same right has been deprived here is a question that can only
11 be answered through a pre-trial evidentiary hearing during which Mr. Johnson,
12 Mr. Ray, and others are put under oath and before this Court.

13 IV. CONCLUSION

14 For all the reasons stated above, Mr. Karatz respectfully requests that the
15 Court conduct an evidentiary hearing on the government's misconduct in
16 prosecuting this matter.

17
18 Dated: January 4, 2010

Respectfully submitted,

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