

## Court Holds Prosecutors Violated Constitution by Pressuring KPMG Not to Advance Legal Fees to Former Partners and Employees

On Tuesday, Judge Kaplan of the Southern District of New York, in a strongly worded decision, held that the Department of Justice's ("DOJ") increasingly frequent practice of pressuring corporations under investigation to refuse to pay the defense costs of current or former employees also under investigation, is unconstitutional.<sup>1</sup> Judge Kaplan held that the government violates those employees' Fifth Amendment right to a fundamentally fair trial and their Sixth Amendment right to counsel when it exerts such pressure on a corporation.

The decision, if it stands, will fundamentally change how the DOJ determines whether a company is "cooperating" with an investigation. It will allow companies to avoid the dilemma of having to choose between cooperating (and, in some cases saving the company from what could be the corporate death penalty) and honoring its obligation to advance legal fees to employees so that they may defend themselves. It may also bring peace of mind to employees, who can rest assured that their employers will not leave them "out to dry" without resources to defend themselves properly in complex cases. It may mean a significant shift in the legal landscape of corporate crisis that will benefit companies and their employees.

While the decision has received significant press attention, we review below some of the details that have not been widely reported. We also discuss what may happen next in the KPMG case and, most importantly, what the ruling means for companies and their employees going forward.

### The Thompson Memorandum's Directive to Prosecutors

The *Stein* decision is an indictment of a prevalent prosecutorial tactic, which has its origins in the DOJ's January 20, 2003 memorandum, entitled "Principles of Federal Prosecution of Business Organizations," known as the "Thompson Memorandum." The Thompson Memorandum outlines the criteria to be considered by federal prosecutors in determining whether or not to indict a corporation. One of the factors to be considered is a corporation's level of cooperation with an investigation. As to this factor, the Thompson Memorandum reads, in part:

Another factor to be weighed by the prosecutor is whether the corporation appears to be protecting its culpable employees and agents. Thus, while cases will differ depending upon the circumstances, a corporation's promise of support to culpable employees and agents, either *through the advancing of attorneys fees*, through retaining employees without sanction for their misconduct, or through providing information to the employees about the government's investigation pursuant to a joint defense agreement, may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation.<sup>2</sup>

<sup>1</sup> *United States v. Stein*, S1 05 Crim. 0888 (S.D.N.Y. June 26, 2006) (slip opinion) (the "Opinion").

<sup>2</sup> Opinion at 4 (quoting portion of DOJ's Federal Prosecution of Corporations (the "Holder Memorandum"); this part of the Holder Memorandum was repeated unchanged in the Thompson Memorandum) (emphasis in Opinion, not original).

Many corporations and their counsel have read this part of the Thompson Memorandum as a message that the DOJ will not abide a company's decision to advance defense fees to current or former employees under investigation.<sup>3</sup> And, indeed, federal prosecutors have used this language to pressure corporations under investigation into cutting off the payment of defense fees.<sup>4</sup> This is the situation at issue in *Stein*.

## The KPMG Prosecution: Deferred Prosecution for KPMG and Charges against 18 Former Partners and Employees

In *United States v. Stein*, federal prosecutors have accused 18 defendants, including 16 former KPMG partners, of scheming to defraud the IRS by creating tax shelters that helped several hundred clients avoid \$2.5 billion in taxes. In a motion to dismiss the indictment, the defense argued that prosecutors improperly pressured KPMG not to pay defense fees as KPMG wanted desperately to be viewed as cooperative and "in full compliance" with the Thompson Memorandum.

Mired in an investigation that had the potential to make KPMG the next Arthur Andersen, KPMG chose to cooperate with the government, obviously concluding that fighting might be futile. KPMG sought and ultimately obtained a deferred prosecution agreement — allowing it to pay a significant fine and avoid indictment. The Court found, after an evidentiary hearing, that prosecutors, from the beginning of their investigation of KPMG, pressured KPMG to cut off fees to individuals who were targets of the investigation. The Court found that prosecutors "deliberately, and consistent with DOJ policy, reinforced the threat inherent

in the Thompson Memorandum"<sup>5</sup> — a point that was driven home during a meeting between prosecutors and KPMG's counsel, in which one prosecutor stated that they would look at any decision by KPMG to pay fees "under a microscope."<sup>6</sup> Not surprisingly, and as a direct result of the DOJ's pressure, KPMG decided "to cut off all payments of legal fees and expenses to anyone who was indicted and to limit and to condition such payments prior to indictment upon cooperation with the government."<sup>7</sup> In August 2005, KPMG reached a \$456 million deferred-prosecution agreement over the shelters, in which it admitted to criminal wrongdoing and agreed to cooperate with the investigation of its former employees in exchange for avoiding indictment.<sup>8</sup>

## The Violation

Judge Kaplan held that the government's conduct violated the Constitution that it had "sworn to defend."<sup>9</sup> The Court began its legal discussion by acknowledging the importance to both a corporation and its employees of the indemnification and advancement of defense costs to employees defending civil or criminal charges related to their employment.<sup>10</sup> As the Court stated, reimbursement of legal expenses incurred by employees as a result of doing their job "is very much a part of American life. Persons in jobs big and small, private and public, rely on it every day. . . . This right is as much a part of the bargain between employer and employee as salary or wages."<sup>11</sup>

<sup>3</sup> Several recent decisions concerning the obligations of companies and insurers to pay defense costs during the course of civil and criminal proceedings reinforce the predominant view that Sarbanes-Oxley does not prohibit the advancement of defense costs. See, e.g., *Associated Electric & Gas Insurance Servs., Ltd. v. Rigas*, 382 F. Supp. 2d 685 (E.D. Pa. Mar. 17, 2004); *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Xerox Corp.*, 6 Misc. 3d 763, 792 N.Y.S.2d 772 (Sup. Ct. New York County 2004), *aff'd*, 25 A.D.3d 309 (1st Dept. 2006); *Bergonzi v. Rite Aid*, No. Civ. A. 20453-NC, 2003 Del. Ch. LEXIS 117, 2003 WL 22407303 (Del. Ch. Oct. 20, 2003).

<sup>4</sup> See, e.g., Laurie P. Cohen, *In the Crossfire: Prosecutor's Tough New Tactics Turn Firms Against Employees*, *Wall Street Journal*, June 4, 2004 (reporting that certain investigators required that a subject company not advance legal fees to any current or former employee who has invoked his constitutional rights).

<sup>5</sup> Opinion at 32.

<sup>6</sup> *Id.* at 17 & 32.

<sup>7</sup> *Id.* at 33.

<sup>8</sup> *Id.* at 26.

<sup>9</sup> *Id.* at 3.

<sup>10</sup> *Id.* at 34-37 (acknowledging the views that indemnification "encourages corporate service by capable individuals by protecting their personal financial resources from depletion [as a result of] . . . litigation that results by reason of that service" and that advancement is "an especially important corollary to indemnification as an inducement for attracting capable individuals into corporate service") (internal quotation marks and citations omitted).

<sup>11</sup> *Id.* at 1-2.

The Court then analyzed whether the DOJ's conduct had violated the defendants' Fifth Amendment substantive due process right to fairness in the criminal process.<sup>12</sup> The Court found that it had. Preparation for a criminal case of the magnitude of *United States v. Stein* requires substantial resources. The Court held that the DOJ interfered with the defendants' ability to receive an advancement of the significant costs of such a defense, which they would have received but for the DOJ's conduct. This interference impacted "the defendants' ability to present the defense they wish to present by limiting the means lawfully available to them."<sup>13</sup>

Judge Kaplan also found that the prosecutors' conduct infringed the defendants' Sixth Amendment right to counsel.<sup>14</sup> Causing KPMG to cut off payment of defendants' legal expenses invaded the defendants' "right to choose the lawyer or lawyers he or she desires and to use one's own funds to mount the defense that one wishes to present."<sup>15</sup> The Court rejected the government's contention that the defendants did not have a right to spend "other people's money." Although KPMG's partnership agreement did not mandate the advancement of legal expenses, the Court found that "KPMG had an unbroken track record of paying the legal expenses of its partners and employees incurred as a result of their jobs, without regard to cost."<sup>16</sup> Therefore, the defendants had at least an expectation that their legal expenses would be paid by KPMG, and this expectation and the benefits that

would have flowed therefrom, the Court held, was a property interest belonging to defendants, not a third party.<sup>17</sup>

## The Remedy

The Court refused, for now, to dismiss the indictment as a remedy for the government's violations of the defendants' Constitutional rights. Rather, Judge Kaplan allowed the defendants the opportunity to bring a civil action against KPMG for payment and advancement of fees, and suggested that it may be in the government's interest to use its "substantial influence," pursuant to its deferred prosecution agreement with KPMG, to cause KPMG to advance defense costs to the defendants. If KPMG does not advance defense costs to the defendants, then the Court said it would consider the "additional relief," i.e., dismissal of the indictment, sought by defendants.<sup>18</sup>

<sup>12</sup> *Id.* at 39-54. The Court only analyzed the government's post-indictment violations, leaving for another day any analysis of the government's pre-indictment interference with the defendant's Constitutional rights. *Id.* at 67-68. As the Court noted, any analysis of the government's pre-indictment violations would necessarily be grounded solely in the Fifth Amendment because the Sixth Amendment right to counsel does not attach until indictment. *Id.* at 67.

<sup>13</sup> *Id.* at 49.

<sup>14</sup> *Id.* at 54-66.

<sup>15</sup> *Id.* at 55; see also *United States v. Gonzalez-Lopez*, \_\_\_ S.Ct. \_\_\_, 05-352, 2006 WL 1725373 (June 26, 2006) (The Sixth Amendment right to counsel "commands, not that a trial be fair, but that a particular guarantee of fairness be provided — to wit, that the accused be defended by the counsel he believes to be best." . . . "The right to select counsel of one's choice . . . has been regarded as the root meaning of the constitutional [i.e., Sixth Amendment] guarantee.").

<sup>16</sup> Opinion at 38.

<sup>17</sup> *Id.* at 56-57; see also *id.* at 38, n.119 (the defendants "arguably are protected by a contract, implied in fact from KPMG's uniform past practice and the circumstances of the business, pursuant to which they are entitled to have their defense costs paid by KPMG.") As the Court found that KPMG's prior practice of advancing legal fees created a property right, corporations may wish to re-examine their practices and by-laws to ensure they do not unintentionally create such rights.

Many corporations have included provisions in their corporate charters or by-laws mandating the advancement of expenses. "Where such a mandatory provision exists, the rights of potential recipients of such advancement are enforced as a contract." Stephen A. Radin, "Sinners Who Find Religion": *Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing*, 25 REV. LITIG. 251, 264 (2006) (internal quotation marks omitted) (quoting *Gentile v. SinglePoint Fin., Inc.*, 787 A.2d 102, 106 (Del. Ch.), *aff'd*, 788 A.2d 111 (Del. 2001). And, a corporation can be compelled by court order to advance expenses. See, e.g., *Homestore, Inc. v. Tafeen*, 888 A.2d 204 (Del. 2005) (affirming Chancery Court's order compelling advancement of fees to former corporate officer where company's by-laws provided officers with unconditional mandatory right to advancement). In fact, Delaware's corporate law specifically allows the Chancery Court to "summarily determine a corporation's obligation to advance expenses (including attorney's fees)." Del. Code Ann. tit. 8, § 145(k).

<sup>18</sup> *Id.* at 73-80.

## What Happens Next in the KPMG Prosecution?

Although the opinion is very thorough, technically, it does not resolve the issues it addresses. At the end of the day, the Court did not actually order the government or KPMG to advance legal fees to the individual defendants. The outcome the Court hopes to achieve is fairly obvious: the government will now assure (or, reassure) KPMG that it has no objection to KPMG advancing legal fees and that the deferred prosecution agreement will not be jeopardized if KPMG chooses to do so. KPMG will then advance the fees and the case will proceed to trial in September.

If KPMG does not advance the fees — either because it does not receive the “green light” from the government or because it decides to “stick to its guns” — Judge Kaplan has made clear that he will either order KPMG to do so in a separate (though related) civil action he invited the KPMG defendants to file, or he will dismiss the indictment. That could set in motion an appeal by the government that will allow the Second Circuit Court of Appeals to address — head on — whether Judge Kaplan is correct that the Thompson Memorandum is, at least in part, unconstitutional. It is unclear from the early comments by the U.S. Attorney where this case is headed but, given the approaching trial date (one Judge Kaplan is unlikely to move), look for significant developments in the coming weeks.

## What Does This Mean For Companies And Employees?

It appears that, at least for now, the government has been dealt a significant blow that will force it to tread carefully before taking any action that might be viewed as meddling in a company's decision to advance fees to individual employees under investigation for, or charged with, crimes. Corporations can enjoy some newfound confidence that — whatever decision they make in this regard — it is less likely that prosecutors will hold it against them in evaluating whether or not they are being cooperative.

These issues, however, remain highly sensitive and need to be evaluated carefully on a case-by-case basis. It may also be a good time for companies to review and document their policies and practices in this area. To the extent companies have discretion to pay

legal fees for individuals facing criminal charges, it makes sense to review how that discretion has been exercised in the past and make decisions about such matters before a corporate crisis arises.



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