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A legal update from Dechert's White Collar and Securities Litigation Group

Second Circuit Affirms Dismissal of Indictment Against Former KPMG Partners Where Government Caused KPMG Not to Pay Defendants' Legal Fees

Rejecting aggressive tactics by federal prosecutors in white collar criminal cases, on August 28, 2008, the United States Court of Appeals for the Second Circuit affirmed an order by U.S. District Court Judge Lewis A. Kaplan, dismissing an indictment against thirteen former partners of the accounting firm KPMG, LLP. The case has been described by the U.S. Attorney's Office for the Southern District of New York as the "largest criminal tax fraud prosecution ever." This decision is critically important in the world of corporate criminal investigations because it sends a strong message to prosecutors that aggressive tactics that tread on the sanctity of the attorney-client relationship will not be tolerated by courts. It is a useful reminder that prosecutors' conduct "behind closed doors" can be exposed in open court and it also clarifies the scope of the Sixth Amendment right to counsel.

After an extensive hearing, the District Court found that KPMG, consistent with its historical practice, ordinarily would have advanced legal fees to the individual partners under indictment for conduct related to their work at KPMG. The District Court found that KPMG decided not to advance fees in this case because the government held the proverbial gun to its head. The Department of Justice's ("DOJ") Thompson Memorandum directed prosecutors to consider a business entity's advancement of attorneys' fees to employees as tantamount to protection of culpable individuals and to take that into account in deciding whether or not to indict the firm itself. Moreover, Judge Kaplan found that the prosecutors' statements to counsel for KPMG during the course of negotiations about the fate of the entity made clear that any decision by KPMG to continue advancing legal fees might well result in an indictment of the firm—essentially, the corporate death penalty. KPMG, Judge Kaplan found, had no real choice but to acquiesce. Judge Kaplan concluded that the prosecutors, by orchestrating KPMG's decision to deprive the defendants of funds for their defense, violated the defendants' Sixth Amendment right to counsel and Fifth Amendment right to substantive due process. Judge Kaplan dismissed the indictment.

On appeal, the government argued that KPMG's decision to stop paying legal fees was the result of that firm's independent business judgment about how best to proceed and was not dictated

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by the Thompson Memorandum or by the prosecutors. The government challenged the District Court's holding that the defendants' Sixth Amendment rights had been implicated, since, the government argued, the Sixth Amendment right to counsel does not encompass a right to have a third-party pay legal fees. The government also argued that no Fifth Amendment due process violation occurred because the defendants had not been deprived of any "deeply rooted," fundamental rights. Moreover, the government asserted that, since it was KPMG—not the government—that suspended payment of fees, constitutional limitations on state action could not have been implicated at all. Finally, the government argued that, to the extent any violation occurred, outright dismissal of the case was far too drastic a remedy.

Dechert LLP, on behalf of the Washington Legal Foundation, filed an amicus curiae brief to the Second Circuit, arguing that the District Court's decision should be affirmed.

In affirming the decision, the Second Circuit agreed with the District Court's finding that "but for the Thompson Memorandum and the prosecutors' conduct, KPMG would have advanced legal fees without condition or cap." The court thus turned to deciding whether there was a sufficient nexus between the government's actions and KPMG's conduct such that state action had been established as a matter of law. The court found the requisite state action, explaining that the prosecutors had become "entwined in the control of KPMG" and "forced" KPMG's decision to cut off fees. The court rejected the applicability of a line of cases cited by the government in which no state action was found, where the National Association of Securities Dealers and New York Stock Exchange had conducted investigations in cooperation with the Securities and Exchange Commission. In those cases, the Second Circuit explained, the private actors had independent regulatory interests and motivations, whereas in the KPMG case, the government's "threat of indictment was easily sufficient to convert [KPMG,] its adversary[,] into its agent."

Having found state action, the court went on to clarify the bounds of the Sixth Amendment right to counsel. The court noted that "the Sixth Amendment prohibits the government from impeding the supply of defense resources (even if voluntary or gratis) absent justification," and held that the government's action unconstitutionally deprived some of the defendants of counsel of their choice, interfered with other defendants' relationships with counsel, and impaired all defendants' ability to mount a defense.

The court rejected the government's argument that any constitutional violations had been remedied, since "[t]he appropriate remedy for a constitutional violation is one that as much as possible restores the defendant to the circumstances that would have existed had there been no constitutional error." The only such remedy in this case was the "unconditional, unlimited advancement of legal fees," from the inception of the matter, which, of course, was no longer possible. The alternative remedies identified by the government—allowing the defendants more time to prepare for trial after the prosecutors stated explicitly in open court that they would not object to KPMG advancing fees—"were not enough" to "restore defendants to the status quo ante." Thus, the court concluded that dismissal was the only appropriate remedy for violation of the defendants' Sixth Amendment rights. The Second Circuit did not deem it necessary to address whether the government's conduct also violated the Fifth Amendment.

Interestingly, one thing the Second Circuit's decision did not do is lead directly to change in DOJ policy, as the DOJ had already decided to change its policy. On August 28—the same day the Second Circuit issued its opinion—new DOJ guidelines took effect that specifically prohibit prosecutors from taking into account a corporation's decision to pay legal fees for its employees. The court's decision and the new DOJ policy put corporations on solid footing when they advance legal fees to employees under investigation or indictment and confirm the appropriateness of this longstanding practice.

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