

Reduced US government interference in accused executives' defence arrangements



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TWO RECENT DEVELOPMENTS, A retreat by the Department of Justice (DoJ) from its prosecution guidelines and an influential Court of Appeals decision, have significantly improved the ability of accused executives to defend themselves in federal criminal prosecutions.

In *United States v Jeffrey Stein et al* [2008] a US Court of Appeals affirmed a federal trial court's dismissal of indictments involving fraudulent tax shelters against a group of KPMG senior partners and employees. The Court found that the DoJ had exerted improper pressure on KPMG to force a termination of KPMG's earlier agreements to pay its partners and employees' legal defence fees, among other conditions required to avoid an indictment of the company. The Court held that such pressure violated the KPMG partners' and employees' constitutional rights to effective legal counsel.

That same day, 28 August 2008, the DoJ announced a significant change in the prosecution guidelines that were so heavily criticised by the trial and appellate courts in *Stein*. It revised the guidelines to restrict its previous requirements that companies under criminal investigation and seeking 'co-operation credit' should agree:

1) to waive attorney-client privilege;

- 2) to waive the right to participate in joint defence agreements with employees under investigation;
- 3) to terminate or discipline such employees; and
- 4) not to pay those employees' legal defence fees.

BACKGROUND

Following high-profile collapses of Enron, WorldCom, Arthur Andersen, and other indicted companies employing executives suspected of criminal misconduct, the DoJ developed prosecution guidelines designed to encourage maximum corporate co-operation in exchange for the DoJ's decision not to indict company employers. By establishing co-operation, companies might avoid indictment and its potentially disastrous effects.

The co-operation credit guidelines actually capitalised upon earlier standards the DoJ used to assess corporate co-operation with investigations and prosecutions and to remove corporate incentives to 'circle the wagons' and otherwise impede the DoJ's investigatory and prosecutorial efforts. The revised 2003 guidelines, known as the 'Thompson Memorandum', required companies under scrutiny to establish their good faith by waiving attorney-client and work product privileges, surrendering the results of their internal investigations, and halting payment of legal fees for executives or employees under investigation.

The Thompson Memorandum generated heavy criticism from the American Bar Association and other interests. It prompted Congressional hearings to investigate the Memorandum's potential violation of constitutional rights, including the effective assistance of counsel under the Sixth Amendment to the US constitution, and the right to a fair trial under the Fifth Amendment.

Concerns over the Fifth and Sixth Amendment issues reached a high level when, in 2006, a federal court in New York dismissed federal fraudulent tax shelter indictments of six KPMG senior

partners. Judge Lewis A Kaplan held that the Thompson Memorandum violated the KPMG partners' Fifth and Sixth Amendment rights by effectively depriving them of a fair trial and effective assistance of counsel, respectively, after KPMG agreed to stop funding their legal defence fees in its efforts to win co-operation credit from federal prosecutors. Kaplan J found a 'menace inherent in the Thompson Memorandum', among other disturbing instances of pressure applied against KPMG to abandon its obligations to partners and employees as a sign of good faith co-operation with the DoJ's investigation.

FACTS IN STEIN

In February 2004 KPMG learned that 20 to 30 of its senior partners and employees were the subject of a grand jury investigation into fraudulent tax shelters. The investigation had been launched after US Senate subcommittee hearings held in 2002 into KPMG's possible involvement in creating and marketing fraudulent tax shelters. By 2004 KPMG had already determined to 'clean house' by terminating or transferring its senior partners who had testified at the hearings. It had also entered into consulting and other agreements to pay those senior partners' legal defence fees, and announced that it would provide competent counsel to represent any partner called to testify in the grand jury investigation.

KPMG began a series of meetings with federal prosecutors in 2004 in an effort to avoid its indictment. The earlier collapse of Arthur Andersen, another large accounting firm, after an indictment provided a strong incentive to avoid an indictment at any cost. KPMG's counsel in the investigation therefore voiced the company's intent 'to co-operate fully with the government's investigation' and announced: 'the company's goal was not to protect individual employees but rather to save the firm from being indicted'.

The price of KPMG's avoiding an indictment was high. In a series of meetings in early 2004 government

prosecutors demanded increasingly restrictive conditions on KPMG's payment of its partners' legal defence fees. The company first suggested that it would, if contractually possible, terminate payment of legal fees to any employee who invoked the Fifth Amendment's privilege against self-incrimination. Federal prosecutors were dissatisfied with that restriction, and insisted that KPMG tell all its employees that they should be 'totally open' with prosecutors, even if that meant admitting criminal wrongdoing or meeting with prosecutors without defence counsel present.

KPMG responded to prosecutors' demands by announcing a new fee policy applicable to those under investigation. Although its agreements with terminated partners and others under investigation had imposed no such limits, the company announced a new fee policy capping defence costs at \$400,000 per employee, conditioning payment on the employee's co-operation with the government, and terminating the obligation when an employee was indicted.

The new fee policy did not placate federal prosecutors, who successfully pushed KPMG to advise its employees that they could 'deal directly with government representatives without counsel'. Some KPMG employees apparently did deal with prosecutors without counsel present, and KPMG announced it would stop paying its employees' legal fees, if such employees were deemed unco-operative by the prosecutors. As Kaplan J observed: 'The employees either knuckled under and submitted to interviews, or they were fired and KPMG ceased advancing their fees.'

Nineteen of KPMG's partners and employees were subsequently indicted. By contrast, KPMG's efforts achieved a

mixed success. It entered into a deferred prosecution agreement (DPA) – literally a criminal confession of judgment [C1] – in August 2005. Under the DPA, the company agreed to 'extensive wrongdoing', paid a \$456m fine, and committed itself to co-operation in any future government investigation or prosecution. In fact, the co-operation demanded under the DPA meant observance of the Thompson Memorandum's requirements. When a series of indicted KPMG partners sought dismissal of their indictments based upon prosecutors' interference in their receipt of legal fees from KPMG, the company readily conceded that the Memorandum had influenced its decision. [C2]

KPMG's concession of influence was an understatement. Kaplan J convened a hearing on the issue and found that prosecutors had used the Thompson Memorandum to 'minimise the involvement of defence attorneys' and that 'but for the Thompson Memorandum and the prosecutors' conduct, KPMG would have paid defendants' legal fees and expenses without consideration of cost'. Accordingly, Kaplan J ruled that the defendants' Fifth and Sixth Amendment rights had been infringed. He rejected the prosecution's position 'that defendants have no right to spend "other people's money" on high-priced defence counsel'. He also ruled that defendants 'need not show how their defence was impaired'. After inviting the defendants to file a civil suit against KPMG, Kaplan J ultimately concluded that the only remedy available was outright dismissal of the indictment.

COURT OF APPEALS DECISION

The government appealed Kaplan J's dismissal of the indictment to the Second Circuit Court of Appeals in New York. In a unanimous decision, the Court affirmed Kaplan J's dismissal of the indictment. The

Court rejected the government's insistence that KPMG had been free to 'exercise its business judgment' and concluded that the company had 'assumed a supine position in the DPA – under which KPMG must continue to co-operate fully with the government' or risk a claimed breach of the DPA and inevitable criminal prosecution against it. 'An adversarial relationship does not normally bespeak partnership', the Court observed. 'But KPMG faced ruin by indictment and reasonably believed it must do everything in its power to avoid it.'

In short, the Court found that the government's intervention in KPMG's legal fees agreements had made it the 'paymaster' of the defendants' legal fees, and the 'menace inherent in the Thompson Memorandum' inflicted irreparable consequences on the indicted employees' right to counsel guaranteed by the Sixth Amendment.

DoJ RETREATS ON PROSECUTION GUIDELINES

On the same day the Court of Appeals handed down its decision affirming Kaplan J's dismissal of the indictments, the DoJ announced its revision of charging guidelines for prosecuting corporate fraud. The new guidelines substantially affect prosecutors' assessment of corporate co-operation credit, and reversed many previous principles, including advancement of legal fees to employees when evaluating co-operativeness. The new guidelines provide that:

- credit for co-operation no longer depends upon waiver of attorney-client and work product privileges, but rather on the disclosure of relevant facts;
- mere participation in a joint defence agreement will not render a corporation ineligible for co-operation credit;
- prosecutors may not consider a corporation's advancement of legal fees to employees when evaluating co-operation; and
- a corporation's retention or sanction of a culpable employee will no longer

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be a factor in evaluating a corporation's co-operation credit.

The DoJ says that the reasons for its policy changes are 'in keeping with the long-standing tradition of refining the Department's policy guidance in light of lessons learned from our prosecutions', among other sources. However, the KPMG experience was clearly a prime contributor to the move, as evidenced by the DoJ's unprecedented and immediate inclusion of its revised guidelines in the United States Attorneys Manual, which is binding on all federal prosecutors in the DoJ.

United States v Jeffrey Stein et al [2008] WL 3982104, F3d (2d Cir 2008)

COMMENT

Whether the *Stein* decision and the DoJ's revision of its guidelines represent a significant change in federal corporate

criminal prosecution dynamics remains to be seen. The new guidelines offer sufficient flexibility and discretion to tempt some corporate defendants to share privileged communications or to decline joint defence or other co-operation agreements with employees and others. The sheer risk to which public and other large companies are exposed in credit and financial markets represents a continuing source of leverage prosecutors have available to extract the co-operation they deem acceptable.

The *Stein* decision and the new guidelines also suggest grounds for continuing tension between corporations and their employees targeted by federal prosecutors. As in *Stein*, may **[C3]** such agreements to advance legal fees and

costs rest upon contractual commitments that corporations may not easily disavow in their haste to avoid indictments. The new guidelines' creation of further areas of discretion involving waiver of privileges, for example, still create areas of ambiguity.

Corporations are well-advised to anticipate potential investigatory circumstances as a risk management function. Contractual arrangements, policies, and procedures should accommodate corporate and potentially conflicting employee interests before criminal inquiries arise. Such anticipation should include, for example, concrete policies implementing internal investigations, the results of which are likely still accessible to prosecutors assessing corporate co-operation.