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Court Finds Thompson Memorandum Violative of Fifth & Sixth Amendment Rights

On June 26, 2006, in *United States v. Stein*,¹ Southern District of New York Judge Lewis Kaplan held that by putting pressure on KPMG not to advance its employees' attorneys' fees, the government² violated those employees' Fifth and Sixth Amendment rights to due process and the effective assistance of counsel. However, Judge Kaplan held that the violations did not warrant dismissal of the charges against the defendants, nor could he order the government or KPMG (which was not a party) to advance defendants' attorneys' fees. Instead, Judge Kaplan ordered the U.S. Attorney not to consider the advancement of attorneys' fees when deciding whether to indict KPMG, and he directed the employees to seek advancement of their fees from KPMG, urged the government to pressure KPMG to advance the fees, and strongly hinted that he would, if necessary, grant relief to the employees against KPMG.

I. BACKGROUND

In the wake of high profile accounting scandals such as Enron, WorldCom, and Adelphia, prosecutors and regulatory bodies have placed increasing pressure on corporations to cooperate with their investigations. The Securities and Exchange Commission issued the "Seaboard Release," in which it stressed cooperation as a primary factor in whether or not it would take action against a company.³ The New York Stock Exchange included cooperation as factor in its *Information Memo Regarding Factors Considered in Determining Sanctions*.⁴ Most relevant here, however, was the Department of Justice's

¹ S1 05 Crim. 0888 (S.D.N.Y. June 26, 2006).

² Judge Kaplan held that the Department of Justice ("DOJ")'s Thompson Memorandum, and the United States Attorneys Office ("USAO")'s investigation, each violated the individual defendants' constitutional rights.

³ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (October 23, 2001); see Joel M. Cohen & Jason A. D'Angelo, *SEC on Corporate Penalties: 2 Steps Forward, 1 Step Backward*, 235 N.Y.L.J. (Feb. 10, 2006).

⁴ Executive Vice President Susan Merrill, Factors Considered by the New York Stock Exchange Division of Enforcement in Determining Sanctions, NYSE Information Memo No. 05-77, issued October 7, 2005,

“Thompson Memorandum,” which requires that federal prosecutors consider specific enumerated factors in deciding whether or not to bring charges.

The “Thompson Memorandum” (officially the *Principles of Federal Prosecution of Business Organizations*), was issued by then United States Deputy Attorney General Larry D. Thompson on January 20, 2003.⁵ A product of the President’s Corporate Fraud Task Force, the Thompson Memorandum set forth guidelines to direct the exercise of prosecutorial discretion.

The Thompson Memorandum borrowed heavily from its predecessor, the 1999 Holder Memorandum, which set forth similar guidelines,⁶ but unlike the Holder Memorandum, the Thompson Memorandum is binding on all federal prosecutors, thus forcing them to consider each of the enumerated factors when considering an indictment. One factor prosecutors must consider is a corporation’s “willingness to cooperate in the investigation of its agents . . . [as opposed to] a corporation’s promise of support to culpable employees and agents, either through the advancing of attorneys fees [or otherwise].”⁷

Commentators have been critical of the Thompson Memorandum, and prosecutors, for the pressure they put on corporations under investigation. Companies under threat of indictment, however, may have no viable choice but to attempt to satisfy the prosecutors’ view of cooperation. “Few if any competent defense lawyers would advise a corporate client at risk of indictment that it should feel free to advance legal fees to individuals in the face of the language of the Thompson Memorandum itself.”⁸

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available at [http://apps.nyse.com/commdata/PubInfoMemos.nsf/o/85256FCB005E19E8852570920068314A/\\$FILE/Microsoft%20Word%20-%20Document%20in%2005-77.pdf](http://apps.nyse.com/commdata/PubInfoMemos.nsf/o/85256FCB005E19E8852570920068314A/$FILE/Microsoft%20Word%20-%20Document%20in%2005-77.pdf); see also Susan L. Merrill, *NYSE Chief of Enforcement on Sanctions, Investigative Cooperation*, 235 N.Y.L.J. (Mar. 8, 2006).

⁵ Deputy Attorney General Larry D. Thompson, *Principles of Federal Prosecution of Business Organizations*, U.S. Dep’t of Justice (Jan. 20, 2003), at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm (last visited June 27, 2006).

⁶ Eric Holder, *Federal Prosecution of Corporations*, U.S. Dep’t of Justice Memorandum (June 16, 1999), at <http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html> (last visited June 27, 2006).

⁷ Thompson, *supra* note 5, at §§ II, ¶ 4 & VI (B), ¶ 5. A footnote to this language states that a corporation’s compliance with governing state law will not be considered a failure to cooperate.

⁸ Carmen Couden, *The Thompson Memorandum: A Revised Solution or Just a Problem?*, 30 J. Corp. L. 405 (2005); Peter J. Henning, *Overcriminalization: The Politics of Crime*, 54 Am. U. L. Rev. 669 (2005); Stein, *supra* note 1, at 51.

II. FACTS AND PROCEDURAL HISTORY OF *STEIN*

The IRS began investigating tax shelters marketed by KPMG at about the same time the Deputy Attorney General issued the Thompson Memorandum. Finding the tax shelters illegal, the IRS made a criminal referral to the DOJ, which passed it on to the USAO. Judge Kaplan found that the USAO (relying on the Thompson Memorandum) made clear to KPMG that, in order to avoid indictment, it should limit or cease advancement of attorney's fees, and require full cooperation with the government as a condition of any legal fees it did advance. "[W]hile the USAO did not say in so many words that it did not want KPMG to pay legal fees, no one at the meeting could have failed to draw that conclusion."⁹

KPMG had a longstanding practice of advancing legal fees for its partners and employees, without a preset limit or a condition requiring cooperation with the government.¹⁰ It was not clear, however, that KPMG had any explicit legal or contractual obligation to do so. Acutely aware of Arthur Andersen's indictment and ensuing demise, KPMG felt that it had no option other than to demonstrate full cooperation with the USAO, and instructed its employees and former employees that it would cap advancement of attorneys' fees and only advance fees if the individual cooperated with the government.¹¹

On August 29, 2005, KPMG entered into a Deferred Prosecution Agreement ("DPA") under which KPMG would avoid criminal indictment. One provision of the DPA obliges KPMG to cooperate extensively with the government, both in general and in the government's prosecution of KPMG employees. KPMG ceased advancing attorneys' fees to indicted employees.¹²

The USAO brought indictments against 15 current and former KPMG employees (the "KPMG Defendants") for their role in the illegal tax shelters. With the advancement of their legal fees cut off, those employees brought a motion "to dismiss the indictment or for other relief on the ground that the government had interfered improperly with the advancement of attorneys' fees by KPMG in violation of their constitutional rights."¹³ The government denied that the KPMG Defendants had any right to those advancements and denied that KPMG stopped advancement at the government's instruction or request.¹⁴

⁹ *Id.* at 17.

¹⁰ *Id.* at 9-10.

¹¹ *Id.* at 19. The USAO also pressured KPMG into telling its employees and former employees that they did not need counsel when meeting with the government. *Id.* at 21.

¹² *Id.* at 26-27.

¹³ *Id.* at 28.

¹⁴ *Id.* at 28-29.

Judge Kaplan held a three-day evidentiary hearing with limited discovery on the motion.¹⁵ The parties submitted notes of the meetings between KPMG's counsel and the USAO, and those present at the meeting testified as to their understanding of what those notes meant, among other things. KPMG was present throughout the hearing and was given the opportunity to be heard. KPMG submitted a memorandum, but made no offer of any evidence.¹⁶

Based on the evidence and testimony at the evidentiary hearing, Judge Kaplan reached four primary factual conclusions. "*First*, the Thompson Memorandum caused KPMG to consider departing from its long-standing policy of advancing legal fees and expenses of its personnel in all cases and investigations even before it first met with the USAO. . . . *Second*, the USAO . . . reinforced the threat inherent in the Thompson Memorandum. . . . *Third*, the government conducted itself in a manner that evidenced a desire to minimize the involvement of defense attorneys. . . . *Fourth* . . . [a]bsent the Thompson Memorandum and the actions of the USAO, KPMG would have paid the legal fees and expenses of all of its partners and employees both prior to and after indictment, without regard to cost."¹⁷

III. RATIONALE OF THE COURT

Judge Kaplan rejected the government's argument that the KPMG Defendants had no right to advancement of their legal fees, declaring that, due to KPMG's history of advancing legal fees, "[a]ll of the KPMG Defendants therefore had, at a minimum, every reason to expect that KPMG would pay their legal expenses in connection with the government investigation."¹⁸ In particular, the court noted that in a 1974 criminal case, KPMG "paid the pre- and post indictment legal fees for the individual [employees]," without limitation, thus demonstrating their prior history.¹⁹

Rather than dwelling on the KPMG defendants' (unclear) right to have their fees paid, Judge Kaplan instead focused on the broader constitutional right to fairness in a criminal proceeding, including

15 *Id.* at 30-31.

16 *Id.* at 3.

17 *Id.* at 32-33. All of these factual conclusions were contested.

18 *Id.* at 38. KPMG's prior history is the relevant inquiry because it is a limited liability partnership, whereas indemnification and advancement of fees to corporate officers and directors is addressed by statute in all states and generally governed by a corporation's charter or by-laws, which typically provide protection to the full extent allowed by law. *See Id.* at 35; Del. Gen. Corp. Law § 145(a) ("[a] corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative").

19 *Id.* at 10.

freedom from government interference with the preparation of one's defense.²⁰ This right is not found in the text of the Constitution itself, but Judge Kaplan noted the Supreme Court's repeated recognition of a right to fairness, generally premised on a combination of the Due Process Clause of the Fifth Amendment and the right to assistance of counsel under the Sixth Amendment.

Fifth Amendment Violation

Judge Kaplan held that both the Thompson Memorandum and the USAO's actions violated the Fifth Amendment's guarantee of due process. The court first determined that Supreme Court precedent had established that a right to fairness in the criminal process is inherent in the Due Process Clause.²¹ The court then considered whether that right is fundamental, and thus entitled to a strict scrutiny standard as a right "so essential to individual liberty that [it] cannot be infringed by the government unless the infringement is narrowly tailored to serve a compelling state interest."²² While Second Circuit and other circuit decisions had stated that the right to fairness in criminal proceedings is fundamental, Judge Kaplan found it "not necessary, or . . . appropriate, to go that far in order to decide this case." Instead the court determined that, at the very least, certain elements of the right to fair criminal proceedings are fundamental. These include, *inter alia*, the right to represent yourself, the right to assistance of counsel, and, Judge Kaplan held, the "right to obtain and use in order to prepare a defense resources lawfully available to [defendants], free of knowing or reckless government interference."²³

The court held that the government's actions violated the KPMG Defendants' fundamental rights because its conduct was not narrowly tailored to a compelling government interest. The court found that cutting off the legal fees did interfere with the KPMG Defendants' defense, noting the enormity of the case and the burden such fees place on the individuals.²⁴ None of the government's purported interests justified this interference. The court "disposed of quickly" the government's purported interest in punishing those deemed culpable. "The imposition of economic punishment by prosecutors, before anyone has been found guilty of anything, is not a legitimate governmental interest — it is an abuse of power."²⁵

The court also found insufficient the government's other two purported interests: (i) gauging a company's cooperation in order to make proper decisions on whether or not to indict; and (ii) strengthen-

20 *Id.* at 38-39.

21 *Id.* at 39.

22 *Id.* at 45.

23 *Id.* at 47.

24 *Id.* at 48 (there were at least 5 to 6 million pages of documents, 335 depositions, and 195 income tax returns, and "[t]o prepare for an try a case of such length requires substantial resources").

25 *Id.* at 49-50.

ing the government’s ability to investigate and prosecute corporate crime by encouraging companies and employees to cooperate. Acknowledging that these may be compelling governmental interests, Judge Kaplan held that, regardless, the government’s actions were not narrowly tailored to those ends.²⁶ A narrowly tailored provision would have been framed so that “payment of legal fees may cut in favor of indictment *only if* it is used as means to obstruct an investigation.” On the contrary, “the text [of the Thompson Memorandum] strongly suggests that advancement of defenses costs weighs against an organization independent of whether there is any ‘circling of the wagons.’”²⁷ The actions of the USAO also violated the Fifth Amendment for lack of narrow tailoring, because “[t]he USAO took advantage of the uncertainty [surrounding the text of the Thompson Memorandum] by emphasizing the threat.” In doing so, it used the attorneys’ fee issue as a weapon even absent any sign of KPMG obstructing the investigation.²⁸

Sixth Amendment Violation

The court also ruled that the Thompson Memorandum and the USAO’s actions violated the Sixth Amendment right to assistance of counsel.²⁹ This holding was bolstered by *United States v. Gonzalez-Lopez*, No. 05-352 (June 26, 2006) — issued the same day as Judge Kaplan’s opinion — in which the Supreme Court held that lawyers are not fungible, and criminal defendants’ Sixth Amendment right to assistance of counsel includes a right to the particular counsel of their choosing. Judge Kaplan rejected the government’s argument that the right to assistance of counsel attaches only upon the initiation of a criminal proceeding, because here the goal of both the Thompson Memorandum and the USAO’s actions were to limit defendants’ access to funds for their defense (or that result was at least known to be “exceptionally likely”). Having foreseen the constitutional violation, it did not matter that the cause was “set in motion” before the indictments.³⁰

Judge Kaplan also rejected the government’s claim that the KPMG Defendants had no right to “other people’s money.” Relying on principles of common law tort, among others, the court found the KPMG Defendants’ expectation interest sufficiently definite that government interference with that interest could violate a constitutional right.³¹ Accordingly, the KPMG Defendants had also “established that

²⁶ Further, “[t]here is no necessary inconsistency between an entity cooperating with the government and, at the same time, paying defense costs of individual employees and former employees.” *Id.* at 52.

²⁷ *Id.* at 50-51.

²⁸ *Id.* at 53-54.

²⁹ *Id.* at 55.

³⁰ *Id.* at 56.

³¹ *Id.* at 57. The court cites the torts of interference with prospective economic advantage and inducement of breach of contract as support for the declaration that “[t]he law protects such [expectation] interests against unjustified and improper interference.” *Id.* at 57, n. 180. Regardless, even if it could be shown that the

the government's implementation of the Thompson Memorandum impinged on their Sixth Amendment rights to counsel and to present a complete defense."³²

Finally, the court held that the KPMG Defendants are not obligated to establish any prejudice to their defense by virtue of the interference, because the violation is "complete irrespective of the quality of the representation."³³ Moreover, "[e]ven if prejudice were relevant at this stage of the proceedings. . . . this requirement [would] not apply where a violation resulted in a 'structural defect' in the constitution of the trial mechanism. . . . [such as] where a defendant is actively or constructively denied counsel at a critical stage of the trial."³⁴

Fashioning a Remedy

After holding that the government had violated the KPMG Defendants' constitutional rights, the court was faced with the task of fashioning a suitable remedy.³⁵

The Court refused to dismiss the charges against defendants because "remedies for constitutional violations should be tailored narrowly to the injury suffered. Dismissal of an indictment on the grounds of prosecutorial misconduct is an 'extreme and drastic sanction.'"³⁶ The court also found itself unable to order anyone to advance defendants' attorneys fees. The court was also unable to assess a monetary fine against the government due to sovereign immunity,³⁷ and it could not order KPMG to advance because it was not a party in the action.

Absent power over KPMG, the court instead paved the way for defendants to separately seek advancement from KPMG, by: (i) ordering the USAO not to consider KPMG's advancement of legal fees in

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employees had no right to the advancement, the case would not end there because the government's interference with the defense was itself a violation of a fundamental right.

32 *Id.* at 58.

33 *Id.* at 61.

34 *Id.* at 62-63.

35 *Id.* at 61.

36 *Id.* at 69. The court also held that it was premature to consider the government's actions with respect to advancement of legal expenses incurred before indictment, as those expenses were addressed by another pending motion. *Id.* at 67.

37 *Id.* at 70 ("[a]bsent an express waiver . . . money awards (cannot be imposed against the United States").

determining whether or not to bring charges; (ii) opening a docket for the defendants to bring a claim directly against KPMG in front of Judge Kaplan; (iii) strongly hinting that if KPMG did not voluntarily advance those fees he would order it to do so as soon as defendants filed a claim against it;³⁸ and (iv) suggesting that the government should use its apparent influence over KPMG to remedy the wrong it had created by urging KPMG to advance the legal fees.³⁹ Judge Kaplan indicated that if for some reason attorneys' fees were not advanced to the KPMG Defendants he would consider dismissing the indictment.⁴⁰

IV. SIGNIFICANCE OF DECISION

United States v. Stein is certain to ignite debate over the proper limits of government investigation and the bounds of protection afforded by the Fifth and Sixth Amendments.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Kayvan B. Sadeghi at (212) 701-3049 or ksadeghi@cahill.com; Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.

³⁸ *Id.* at 70-78. The court went to lengths to establish that the court had both subject matter and personal jurisdiction it over KPMG for the fee dispute, as ancillary to the proceeding before it. The court also noted in a footnote that if the arbitration clause in most employees' contracts were urged to foreclose the possibility of the KPMG defendants suing KPMG, he might find the clause void as against public policy in order to retain jurisdiction. *Id.* at 78, n. 239.

³⁹ The court did not address how it could now be proper for the government to once again use its influence to force KPMG's hand. This arguably would now be interfering with KPMG's defense, as the government would be influencing KPMG's choice of whether or not to advance or instead preserve (for this and related actions) the defense that they demonstrated good faith and lack of culpability by cutting off the wrongdoers.

⁴⁰ *Id.* at 80.