

*Client Advisory*

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## *District Court Dismisses Charges Against 13 Former KPMG Employees*

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### **Prior Proceedings**

To recap briefly, KPMG was under investigation by the Department of Justice ("DOJ") for promoting allegedly illegal tax shelters. KPMG sought to avoid indictment by cooperating with the government. At the time, DOJ policy with regard to charging corporate defendants was set out in the so-called Thompson Memorandum. (This memorandum has since been revised and re-issued as the McNulty Memorandum.) Among other things, the Thompson Memorandum allowed prosecutors to withhold cooperation credit from companies that advanced legal fees to their culpable employees' counsel. Judge Kaplan found that as part of KPMG's effort to avoid indictment and receive full cooperation credit, KPMG cut off payment of attorneys' fees for any of its employees who were indicted and also declined to pay pre-indictment fees to anyone who invoked his Fifth Amendment rights or otherwise refused to cooperate with the government's investigation.

KPMG was rewarded by DOJ for such conduct, receiving credit for cooperating and avoiding indictment by entering into a deferred prosecution agreement with the government. The government did, however, indict a number of former KPMG employees and others for their participation in the tax shelter scheme. These former employees sought dismissal of the indictment against them, claiming that by threatening to withhold full cooperation credit from KPMG if KPMG paid their attorneys' fees, the government deprived these former employees of their right to the counsel of their choice and interfered with their ability to present their defenses. (Certain former employees also sought

suppression of pre-trial statements to the government on the grounds that those statements were involuntary. *United States v. Stein*, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) ("*Stein II*").

Last year, in a strongly-worded opinion, Judge Kaplan agreed with the defendants that the Thompson Memorandum, and the manner in which the prosecutors wielded it in this case, violated the defendants' Fifth Amendment substantive due process rights and their Sixth Amendment right to counsel. *United States v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006) ("*Stein I*"). Having so found, however, Judge Kaplan refused to dismiss the indictment, opting instead to invite the defendants to sue KPMG for legal fees and, in the interest of expeditious resolution, asserting ancillary jurisdiction over that suit. When the Second Circuit Court of Appeals held that Judge Kaplan lacked such ancillary jurisdiction, *Stein v. KPMG, LLP*, 486 F.3d 753 (2d Cir. 2007), Judge Kaplan sought briefs from the parties as to the appropriate remedy.

In what clearly appeared to be a tactical move designed to force Judge Kaplan to dismiss the indictment, and thus permit a government appeal to the Second Circuit to review Judge Kaplan's constitutional rulings, the government took the position that if Judge Kaplan's finding of unconstitutionality in *Stein I* was correct, dismissal was the appropriate remedy. The government did not, of course, concede the correctness of Judge Kaplan's constitutional analysis. In effect, the prosecution challenged Judge Kaplan either to change his mind as to whether there

was a constitutional violation or to dismiss the case and risk being overturned on appeal.

## The Most Current Kaplan Decision

Judge Kaplan's latest opinion runs sixty-four pages. In it Judge Kaplan took the opportunity to expand the record and buttress both prongs of his constitutional analysis. *United States v. Stein*, \_\_\_ F. Supp. 2d \_\_\_, No. S1 05 Crim. 0888 (S.D.N.Y. July 16, 2007) ("*Stein III*"). As to the substantive due process argument, Judge Kaplan noted that he is well aware that where an amendment provides the source of constitutional protection, the language of the amendment, not generalized notions of due process, must guide the constitutional analysis. He also described *Stein I*'s finding of a substantive due process violation as an alternative holding that would be material only if the Court of Appeals disagreed with his Sixth Amendment argument.

Nonetheless, he then proceeded to engage in yet another, new substantive due process analysis: "Just as prosecutors used KPMG to coerce interviews with KPMG personnel that the government could not coerce directly, they used KPMG to strip any of its employees who were indicted of means of defending themselves that KPMG otherwise would have provided to them. Their actions were not justified by any legitimate governmental interest. Their deliberate interference with the defendants' rights was outrageous and shocking in the constitutional sense because it was fundamentally at odds with two of our most basic constitutional values – the right to counsel and the right to fair criminal proceedings." He therefore held that the government's conduct impinged upon a fundamental right without being narrowly tailored to serve a compelling governmental interest and that it constituted "outrageous government conduct" that "shocks the conscience." Significantly, Judge Kaplan acknowledged that this additional substantive due process finding in *Stein III* was not necessary for purposes of determining the appropriate remedy and that he made this finding "because it may prove significant to a reviewing court."

The most legally significant additions made in *Stein III* relate to the Sixth Amendment analysis. To refute the government's claim that in *Stein I* he

misinterpreted the Thompson Memorandum, Judge Kaplan bolstered his factual findings that the Thompson Memorandum called for the withholding of cooperation credit where fees are paid for culpable employees. To make this point, Judge Kaplan quoted at length from Senate testimony, law review articles, and other published materials. He found his conclusion is supported by the text of the memorandum and is shared by the defense bar, legal scholars, and KPMG's counsel. This shared understanding is that the Thompson Memorandum discouraged payment of legal fees for company employees because such payment would put the company at greater risk of a corporate indictment.

Next, responding to the government's claim that KPMG made its decision to cut off funding on its own and free from the government's influence, Judge Kaplan reiterated his factual finding that KPMG's decision not to advance fees post-indictment came in response to government pressure. Specifically, tracing the evolution of KPMG's decision to break with its past practice of paying employees' fees, Judge Kaplan found that it was not until after a meeting with the government – in which prosecutors raised the Thompson Memorandum and indicated that any payment of fees would be examined "under a microscope" – that KPMG decided to condition the payment of fees upon cooperation with the government and to cut off fees upon indictment. Judge Kaplan made a factual finding that, before this meeting, KPMG intended to adhere to its past policy of advancing fees without conditioning their payment on cooperation with the government.

Judge Kaplan also included in *Stein III* a discussion of newly discovered evidence that confirmed the court's finding that KPMG was cowed by the government into cutting off fees. This new evidence included a compelling voicemail from KPMG's chief executive officer to all partners announcing the government's investigation and informing the partners that anyone asked to appear would be represented by "competent counsel at the firm's expense." Another piece of new evidence demonstrating the government's influence was KPMG's refusal, following KPMG's first meeting with the government, to sign a fee reimbursement agreement that KPMG had negotiated (but not yet

executed) with one of the defendants just before that first meeting. Yet another piece of new evidence was notes taken by a KPMG executive at a meeting in which KPMG's outside counsel reported back to KPMG about the initial meeting with the government. The notes indicate counsels' understanding that the payment of legal fees would be seen as a sign of non-cooperation. Moreover, Judge Kaplan focused on the fact that KPMG continues to pay the defendants' legal fees in parallel civil cases stemming from the same conduct.

### Analysis

Judge Kaplan's bolstering of this factual record appears to be in response to the Second Circuit's considerable skepticism, expressed in a footnote to its opinion on the ancillary proceeding, that KPMG had a "uniform practice" of paying the legal fees of indicted employees or that these employees were entitled to post-indictment fees. *Stein*, 486 F.3d at 762 n.3. As Judge Kaplan acknowledged in sustaining the indictment against three defendants, if KPMG would not in fact have advanced attorneys' fees (whether legally required to do so or not), the defendants could not show that they were deprived of any right or interest in violation of the Sixth Amendment. The new evidence and the timeline discussed in *Stein III* are therefore aimed at shoring up the finding of a constitutional violation by establishing that the thirteen defendants would have received the advancement of fees post-indictment but for the government's interference. The three defendants as to whom Judge Kaplan did not dismiss the charges could not make such a showing.

Judge Kaplan found a constitutional violation in part because, as a result of the government's action, defense counsel had to withdraw once KPMG refused

to pay their fees, thereby preventing a particular lawyer chosen by a defendant from representing that defendant. In this regard, Judge Kaplan is aided considerably by the Supreme Court's recent decision in *United States v. Gonzalez-Lopez*, 126 S. Ct. 2557 (2006), in which the Court found that interference with a defendant's choice of counsel is never harmless and must lead to reversal, even if the alternative counsel represented the defendant competently. Further, as to those defendants whose counsel had to restrict their work due to KPMG's refusal to pay legal fees, Judge Kaplan found it unconstitutional for the government to prevent KPMG from carrying out its prior practice of spending millions of dollars to mount a defense in a complex, document-intensive case. Put differently, in Judge Kaplan's view, the defendants here are harmed because they are limited to the defense they can afford, and cannot enjoy the defense KPMG can afford and which they would have received but for the government's actions.

The government has already filed its notice of appeal from the dismissal of these charges. It remains to be seen whether the Second Circuit will be as troubled by the limitations placed on the defendants as was Judge Kaplan. Meanwhile, another district court rejected arguments similar to those of the *Stein* defendants, finding that the defendants in that case had not been prejudiced by the prosecutors' conduct, as evidenced by the defense lawyers' continued vigorous representation of their clients. *United States v. Rosen*, 487 F. Supp. 2d 721 (E.D. Va. 2007). That court, however, distinguished *Stein* as a substantially more complex case in which prejudice might be presumed. We anticipate an expeditious decision from the Court of Appeals in the *Stein* case.

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