Investigations and Criminal Litigation

WilmerHale

Limits on Corporate Cooperation—A Judicial Criticism of the Thompson Memorandum

Overview

Judge Lewis A. Kaplan's recent decision in *United States v. Stein*[1] throws into question key aspects of the federal government's strategy for the criminal investigation and prosecution of entities. The decision holds that the government is responsible for the effects of coercing entities to abrogate their obligation to advance and indemnify legal fees, and proposes an important extension to individuals' rights under the Sixth Amendment.

In *Stein*, Judge Kaplan found that, in connection with an ongoing criminal investigation, the US Attorney's Office for the Southern District of New York (the USAO) caused KPMG—one of the world's largest accounting firms—first to limit and then to withhold the advancement of legal defense costs incurred by certain of its then-current and now-former partners and employees. Judge Kaplan held that the government may not interfere in lawful fee advancement and indemnification provisions without specific evidence that the particular payments in question would obstruct the government's investigation. The court's ruling holds at least a portion of the Department of Justice's Principles of Federal Prosecution of Business Organizations to Heads of Department Components and United States Attorneys (the Thompson Memorandum)[2] unconstitutional, insofar as it compels prosecutors to infringe on individuals' rights to counsel. Judge Kaplan declined, for the moment, to dismiss the defendants' indictments or to order any trial-related remedies.[3]

Although the decision's effect is limited to the case before Judge Kaplan, the breadth of its influence may extend much more widely. In particular, it raises questions about the vitality of other potentially coercive measures endorsed by the Thompson Memorandum, as well as other widely used elements of federal criminal enforcement that deserve analysis:

- Should companies reassess their indemnification practices in the wake of *Stein* and, if so, how?
- How can companies avoid becoming unwilling agents in prosecutorial violations of individual rights?
- What actions or statements may constitute prosecutorial coercion?
- How does the holding in *Stein* affect other prosecutorial tactics (described in the Thompson Memorandum or otherwise)?

Case Summary

In August 2005, eight former partners and employees of KPMG (the KPMG Defendants) were indicted for conspiracy to commit tax fraud. On the same day that the indictments were announced, the USAO settled with KPMG, agreeing not to prosecute the firm provided that it continued to fully cooperate with the government's prosecution. KPMG discontinued—with respect to the KPMG Defendants—its practice of advancing defense costs to partners and employees. The KPMG Defendants moved for relief on the grounds that the prosecution interfered with their constitutional rights to a fair trial and to the assistance of counsel. The court scheduled an evidentiary hearing on the motion, and both parties, as well as interested *amici*, filed legal memoranda with the court.

In his ruling, Judge Kaplan found that various statements made and actions taken by the USAO amounted to implicit threats of indictment, and that the prosecutors effectively coerced KPMG to abandon its longstanding practice of indemnifying partners and employees through the advancement of legal defense costs. In a lengthy and thoughtful opinion, Judge Kaplan found that this coercion infringed upon the KPMG Defendants' right to fairness throughout the criminal process as guaranteed by the Fifth Amendment, as well as the KPMG Defendants'

post-indictment right to counsel guaranteed by the Sixth Amendment.

The Fifth Amendment protects a defendant's right to a fair trial, and the Sixth Amendment ensures choice and assistance of counsel. Central to his opinion is Judge Kaplan's finding that, but for the coercive tactics employed by the USAO, the KPMG Defendants would have received from KPMG the "lawfully available"[4] resources to mount a defense. By coercing KPMG to cut off the funding of its employees' defense costs under the guise of "cooperation," rather than allowing KPMG to exercise its own business judgment,[5] the government injected unfairness into the criminal process and encroached upon the constitutional rights of the KPMG Defendants.

Judge Kaplan recognized the government's compelling interest in investigating and prosecuting crime, but nonetheless faulted the government for attempting to make extrajudicial determinations of culpability and punish companies offering assistance to their allegedly culpable employees. Judge Kaplan found the government's practice of drawing negative inferences from the mere existence of fee advancement arrangements to be overly and unjustifiably broad, and that fee advancement arrangements alone could not reasonably result in a determination of non-cooperation. Quite to the contrary, he notes: "[A] company may pay [defense costs] at the same time that it does its best to bare its corporate soul."[6] If the government finds it necessary to consider fee advancement in determining the fullness of a company's cooperation, such consideration should be limited to advancements that are used to obstruct an investigation or prosecution. Without such narrow tailoring, the government's policy runs afoul of the Due Process Clause of the Fifth Amendment and the Sixth Amendment right to counsel.

Perhaps most notably (in terms of constitutional interpretation), Judge Kaplan applied a surprisingly expansive reading of the Sixth Amendment, a reading that has considerable implications for prosecutorial tactics. He found the government's pre-indictment actions incompatible with the Sixth Amendment right to counsel, which typically attaches upon indictment, because the government acted "with the object of having, or with knowledge that [its actions were] likely to have, an unconstitutional effect upon indictment."[7] The Supreme Court and most appellate circuits (including the Ninth Circuit—cited by Judge Kaplan in support of his position) have held that pre-indictment actions cannot violate the Sixth Amendment, as the right to counsel attaches upon indictment.[8] Judge Kaplan appears to suggest that pre-indictment conduct that will clearly have a deleterious effect on the post-indictment right to counsel violates the Sixth Amendment. Whether this reading will withstand challenge is an open question. If it does, it could call into question aggressive prosecutorial tactics now routinely employed during the investigative process.

The opinion invalidates the consideration of fee advancement as promulgated in the Thompson Memorandum. Judge Kaplan warns prosecutors that when they conscript organizations to cause violations of individual rights, those violations are less direct, but no less real. When the government compelled KPMG to withhold legal fees, it interfered with the KPMG Defendants' constitutional rights to a fair criminal process and to the counsel of their choice. Thus, Judge Kaplan holds the government accountable, ironically, for the very obstruction of the legal process that its policy is purportedly designed to prevent.

Constrained by the sovereign immunity doctrine,[9] Judge Kaplan was without power to order the government to pay defense costs, but required the USAO to disregard fee advancement in determining cooperation.[10] He also suggested that the prosecution might rectify the situation it created by using its considerable influence to persuade KPMG to advance the legal fees at issue.[11] Rather than pass on the issue of whether the court could order KPMG (a non-party) to advance fees to the KPMG Defendants, Judge Kaplan allowed the KPMG Defendants 14 days to file a civil complaint against KPMG for declaratory relief, and opened a civil docket for that purpose.[12] Ultimately, Judge Kaplan declined the KPMG Defendants' request to dismiss the indictment but reserved the right to revisit that decision or offer other relief should KPMG, "for one reason or another," not advance the defense costs.[13]

Significant Issues of Importance to Corporate Counsel

Revisiting Advancement Policies and Avoiding Recognition of an Implied Right to Fee Advancement

To be clear, *Stein* does not create a new constitutional right to indemnification.[14] However, Judge Kaplan reviewed KPMG's past indemnification practices, noted that KPMG had a clear historical (though unwritten) practice of advancing defense costs and suggested the existence of an implied right of contract.[15] Before finding their company the target of a government investigation, corporate counsel

should take proactive steps to achieve clarity, avoid judicial recognition of contractual entitlements where none are intended and fully understand any obligations to advance defense costs. We recommend the following measures:

Document Indemnification Policies. Indemnification policies should be clearly documented and should emphasize the company's discretion to refuse, revoke or limit indemnification. *Stein* signals that, when company indemnification policies are unclear, courts may fill gaps on their own initiative, including the recognition of contractual rights. Corporate counsel should consider the specific language and intent of indemnification clauses in employment contracts, both to avoid ambiguity and to allow for more individualized indemnification practices.

Establish Indemnification Procedures. Corporate counsel should also consider establishing processes to carefully scrutinize the advancement of legal fees and to deny advancement where clearly incompatible with the company's interests. For example, a company may establish a committee charged with making advancement decisions. This measure will also help establish that fee advancement is a matter of company discretion, not of right.

Know Past Practices. As Judge Kaplan did in *Stein*, courts may review a company's past indemnification practices to determine whether a right to advancement exists. This appears especially true where advancement is generally granted and indemnification policies are not clearly documented. Corporate counsel should review past indemnification practices to ascertain whether judicial reliance on historical practices could adversely affect the company.

Know Jurisdictional Requirements. In at least one jurisdiction, indemnification is available as a matter of right.[16] Corporate counsel should determine whether their companies—many of which operate in multiple jurisdictions—are statutorily obligated to indemnify employees.[17] Where a legal obligation to indemnify does exist, it may be used to shield prosecutorial pressure to withhold fees.[19]

Know How Indemnification Provisions Affect Various Classes of Employees. When a company's indemnification policies are designed to offer different benefits to different groups, those policies should be clearly articulated. In *Stein*, Judge Kaplan appeared ready to disregard a non-equity partner's partnership status for the purpose of applying indemnification provisions geared only toward employees.

Reexamine Arbitration Clauses Regarding Fee Advancement. Judge Kaplan also hinted strongly that mandatory arbitration clauses relating to fee advancements might be disregarded on public policy grounds when they interfere with the progress of a criminal trial.[19] As they revisit their indemnification practices, corporate counsel may wish to consider whether arbitration clauses serve any practical purpose or should be dispensed with altogether. As an alternative, companies may design more restrictive advancement policies that leave less room for dispute, making arbitration less likely.

When Does the Corporation Become an Agent for the Government's Violation of Individual Rights?

Cooperation is often in a company's best interest, given its apparently talismanic significance to prosecutors and regulators. Cooperation, however, cannot morph into unintended agency with government prosecutors, especially when that agency furthers the violation of individual rights. In *Stein*, Judge Kaplan was openly critical of the lengths to which KPMG went to exhibit its willingness to cooperate with the Justice Department by offering to find, for the KPMG Defendants, lawyers who would urge their individual clients to cooperate with the government.[20] This attempt at cooperation was an "obvious conflict of interest,"[21] and companies should be aware of this and other contexts in which such conflicts may arise.

Termination of Noncooperative Employees. Termination of employees who—citing self-incrimination concerns—refuse to cooperate with investigations, is often in the company's best interest, but may raise concerns when prompted by prosecutorial pressure. The Garrity-Gardner line of cases stands for the proposition that the government cannot terminate public employees for invoking their Fifth Amendment right against self-incrimination.[22] When prosecutors enlist or conscript private companies to issue the cooperate-or-be-fired ultimatum to private employees, the Garrity-Gardner line may well apply, if by extension.

Forcing Employees to Admit Criminal Wrongdoing. During the course of internal investigations, employee candor—even when it means admitting to criminal wrongdoing—is vital and generally encouraged. Companies may agree, as a cooperative measure and after the fact, to disclose the results of internal investigations to prosecutors. However, if the company conducts an internal investigation at the behest of prosecutors and elicits confessions of criminal wrongdoing from employees, disclosure may raise constitutional concerns.

Government-Suggested Financial Restatements. Prosecutors may urge a company under investigation to restate financial statements. When dealing with such a request, corporate counsel should consider whether financial restatement is necessary to disabuse the investing public of misinformation or is instead primarily geared to building a case against targeted individuals.

Restrictions on the Legal Assistance Provided to Employees. *Stein* vindicates the rights of companies to provide—and employees to receive—the resources necessary to mount a legal defense. Even in the provision of those resources, however, constitutional concerns may arise. The above-referenced offer to secure "cooperative" counsel is one obvious misstep; others may exist where the company plays a role in securing employee counsel. Corporate counsel should assess whether it is more appropriate to offer representation by firm counsel assign separate counsel or simply pay for employees' counsel of choice. Corporate counsel should be particularly skeptical of prosecutor-suggested restrictions on legal assistance that may violate the I rights of the individuals. Prosecutorial demands that the company withhold pertinent information from employee-defendants when such action benefits only the prosecution should be carefully considered. Similarly, prosecutor-suggested fee caps may be inappropriate when the primary function of the caps is to tip the scales in the prosecution's favor, when they do not align with the company's past practice, or when they are not commensurate to the complexity of the case faced by the indemnified party.

With few exceptions, the strictures of the Constitution do not apply to private actors, and as such, Judge Kaplan could not sanction KPMG for constitutional violations. Still, one might reasonably infer that his suggestion of and willingness to hear a civil contract suit against KPMG was motivated (at least in part) by displeasure at KPMG's role in the USAO's constitutional overstep. To avoid harming their employees and attracting the court's ire, companies should assert their prerogative to exercise business judgment in dealing with employees and must, whenever possible, avoid assisting prosecutors in the commission of constitutional violations. In short, cooperative companies should avoid doing for prosecutors what the prosecutors may not do themselves.

The Possible Effect of Stein *on Other Prosecutorial Tactics*

To safeguard their rights and those of their employees, as well as to support future challenges to prosecutorial tactics, companies should consider the following during their communications with prosecutors in order to assess whether prosecutorial coercion may be an issue:

- Is settlement or a decision not to indict explicitly conditioned on the company withholding fees from its directors, officers, partners or employees?
- Have prosecutors asked the company to stray from documented or longstanding indemnification policies without alleging that the advancement is being used to frustrate the investigation?
- Do prosecutors persistently broach or return to the topic of fee advancement or regularly remind the company of the Thompson Memorandum factors during the course of settlement negotiations?
- Will the advancement of fees come under heavy scrutiny or be viewed either as non-cooperation or a "reward for bad conduct?"[23]

Judge Kaplan found that the objective perception—as opposed to the subjective intent—of the prosecutors' statements determines whether the prosecution has engaged in coercion. Although the *Stein* prosecutors did not explicitly threaten to indict KPMG if they advanced legal fees, KPMG reasonably understood that avoiding the disastrous consequences of indictment was conditioned on withholding fees from partners and employees.[24] When prosecutors exert a coercive degree of pressure, the validity of other cooperative factors necessarily comes into question.

Common Interest Agreements (Joint Defense Agreements). Prosecutors have an unfavorable view of common interest agreements (not surprising, as they leave less opportunity to isolate individuals) and the Thompson Memorandum implicitly discourages companies from entering into them.[25] Conceptually, common interest agreements strongly resemble the fee advancement arrangements at issue in *Stein*: they inherently affect the ability of employees to mount a legal defense and, absent government interference, may be generally available as a matter of company policy or longstanding practice. Thus, the reasoning in *Stein* appears extendable. Arguably, prosecutorial interference with common interest agreements is more violative than interference with fee advancement because it not only affects the ability of a defendant to mount a defense, but also impinges upon the right of defendants to make their own strategic legal decisions.[26]

Waiver of Privileges and Protections. Unlike the KPMG Defendants' Fifth and Sixth Amendment rights at issue in *Stein*, the attorney-client privilege and work product protection are the company's to assert or waive as it sees fit. Nonetheless, Judge Kaplan's characterization of the government's tactics in securing cooperation raises the question of whether the notion of voluntary waiver in prosecutions of business organizations is fiction. If, as Judge Kaplan states, the Thompson Memorandum implicitly threatens indictment, and prosecutors implementing the guidance act coercively,[27] waivers made in the face of the Thompson Memorandum may be more appropriately described as compelled, rather than voluntary.[28]

Government Interference in Company-Employee Communications. Judge Kaplan took issue with KPMG's willingness to revise a factually and legally accurate internal communication to its employees concerning their legal rights in order to emphasize points favorable to the government.[29] Corporate counsel should establish and disseminate standard language explaining employees' rights during internal and government investigations and, barring exceptional circumstances, deny requests to substitute the company's language with that offered by prosecutors.

Conclusion

Whatever else *Stein* does, there is little question that it underscores the overwhelming leverage that prosecutors have and use to pressure organizations under the guise of cooperation. In *Stein*, the government's actions crossed the line between appropriately applied leverage and inappropriate coercion. It also appears that these high-pressure tactics may have led KPMG to facilitate the USAO's constitutional violations. Corporate counsel should respond proactively to *Stein* and assess current indemnification policies with an eye toward securing the company's ability to exercise discretion in advancing fees to directors, officers, partners and employees. Corporate counsel should also be mindful of prosecutorial coercion and how that coercion may affect the use and validity of certain tactics. *Stein* raises an interesting question: when the government brings its full powers to bear, can a company truly cooperate of its own volition? If not, *Stein* may well represent the high-water mark for the recently- and greatly-expanded power of the Justice Department.

NOTES

1. *United States v. Stein,* No. 05-888 (S.D.N.Y. June 26, 2006).
2. Memorandum from Larry D. Thompson, Deputy Attorney General, on Principles of Federal Prosecution of Business Organizations to Heads of Department Components and United States Attorneys ... (Jan. 20, 2003).
3. Note that in a subsequent intervening decision, Judge Kaplan suppressed certain statements made by a number of the KPMG Defendants as involuntary. Judge Kaplan found that the government's actions in pressuring KPMG to take action against certain of the KPMG Defendants, including withholding the payment of legal fees and threatening termination, were coercive and went beyond the bounds of appropriate government action. See *United States v. Stein,* No. 05-888 (S.D.N.Y. July 26, 2006).
4. *Stein*, No. 05-888, slip op. at 47. The characterization of funds made available by fee advancement as "lawful" appears to distinguish this case from *United States v. Monsanto,* 491 U.S. 600 (1989), in which the Supreme Court refused to recognize a constitutional right to use forfeited assets to fund a legal defense.
5. Acknowledging the historical underpinnings and practical benefits of fee advancement arrangements, and the public interests they serve, Judge Kaplan remarked that fee advancement arrangements facilitate "the hiring of competent and honest employees" and comport with notions of fairness—employees exposed to personal liability by virtue of job performance should be able to seek assistance from their employers. *Stein*, No. 05-888, slip op. at 47.
6. Id. at 52.
7. Id. at 56.
8. See, e.g., *Texas v. Cobb*, 532 U.S. 162, 167-168 (2001) ("[The Sixth Amendment right to counsel] does not attach until a prosecution is commenced, that is, at or after the initiation of adversary judicial criminal proceedings—whether by way of formal charge, preliminary I hearing, indictment, information, or arraignment.") (citations omitted); *United States v. Hayes*, 231 F.3d 663 (9th Cir. 2000) ("[Appellant] had not yet been the subject of a formal charge, preliminary hearing," indictment, information or arraignment. Under these circumstances, the Sixth Amendment right to counsel did not apply.")
9. *Stein,* No. 05-888, slip op. at 73.
10. Id. at 83.
11. Id. at 79.
12. Id. at 76-78. On July 10, 2006, the KPMG Defendants filed a complaint against KPMG in the civil docket (06 Civ. 5007 (LAK) seeking advancement of fees. KPMG thereafter moved to dismiss the complaint for lack of subject matter jurisdiction and on the merits. In an opinion dated September 6, 2006, Judge Kaplan denied KPMG's motion in its entirety, holding that the Court has ancillary jurisdiction to hear the advancement claims and that the KPMG Defendants are otherwise not obligated to arbitrate the advancement dispute for a litany of reasons. See *U.S. v. Stein,* 05 Crim. 0888 (LAK); 06 Civ. 5007 (LAK) (S.D.N.Y. September 6, 2006).
13. Id. at 80.
14. At least one academic commentator has suggested that Judge Kaplan's opinion elevates the contractual—and in certain states, statutory—right of indemnification to the level of constitutional entitlement. This view is unsupported by the opinion. In explaining, as a principle of American law, that employers often indemnify employees for legal expenses arising from their occupational duties,

Judge Kaplan makes clear that such indemnification is "not of constitutional dimension" and "not [as] universal" as the rights to a fair trial or assistance of counsel afforded by the Due Process Clause of the Constitution. *Stein,* No. 05-888, slip op. at 1. Rather than create new constitutional entitlements, Judge Kaplan's opinion restates the KPMG Defendants' well-established rights of due process and assistance of counsel and finds that where the government interferes with the bargained-for or impliedly contractual (not constitutional) right to indemnification, that interference offends the Fifth and Sixth Amendments.

15. *Stein,* No. 05-888, slip op. at 38 n.119.

16. See CAL. LABOR CODE 5 2802(a) ("An employer shall indemnify his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties, or of his or her obedience to the directions of the employer, even though unlawful, unless the employee, at the time of obeying the directions, believed them to be unlawful.")

17. Corporate counsel should note that the applicable statute may appear in the jurisdiction's corporation laws, labor laws or elsewhere in the statutory code.

18. The Justice Department carves out an exception for companies who are statutorily obligated to advance fees. Thompson Memorandum at 8 n.4. Companies may be able to take advantage of this "legal obligation" exemption, by purchasing employee insurance that is triggered upon the occurrence of certain events (e.g., D&O insurance effective upon the employee's receipt of a target letter). In this scenario, the insurer (who presumably would be immune to prosecutorial pressure) replaces the company as fee advancer. Though this strategy is open to the criticism that it deprives companies of discretion to assist or not assist targeted employees, carefully worded insurance policies may result in a system of fee advancement closely aligned with the company's interests.

19. *Stein,* No. 05-888, slip op. at 78 n.239. With respect to the suit filed by the KPMG Defendants against KPMG, Judge Kaplan stated an intention to review any mandatory arbitration clauses for applicability and, if they apply to the matter before the court, to consider whether they should be disregarded "to the extent that [they] would foreclose an advancement determination in a criminal case by the court in which the indictment is pending." Id.

20. Id. at 18 n.54.

21. Id.

22. In *Garrity v. New Jersey,* 385 U.S. 493,497 (1967) the Supreme Court held that "[t]he option to lose [one's] means of livelihood or to pay the penalty of self-incrimination is the antithesis of free choice to speak out or to remain silent." See also, *Gardner v. Broderick*, 392 U.S. 273,277 (1968) (holding that the government denies due process when it terminates a public employee solely for the employee's refusal to waive immunities to which they are entitled).

23. These points are derived from a series of USAO statements cited by Judge Kaplan as evidence of a coercion. *Stein*, No. 05-888, slip op. at 10-17. The cited statements supported his finding that that the settlement agreement was akin to a "gun held to [KPMG's] head." Id at 2.

24. Id. at 17.

25. Thompson Memorandum at 7-8.

26. See *Stein*, No. 05-888, slip op. at 40-41 ("[T]he government may not both prosecute a defendant and then seek to influence the manner in which he or she defends the case.")

27. Id. at 32.

28. With respect to the waiver of these protections generally, the pendulum may be on the backstroke. The United States Sentencing Commission, which had previously amended its guidelines to encourage prosecutors to reward the waiver has unanimously voted to reverse that amendment. US Sentencing Comm'm, Amendment to the Sentencing Guidelines (May 18, 2006), available at http://www.ussc.gttv/2006guid/FinalUserFdly.pdf.

29. *Stein,* No. 05-888, slip op. at 21.

FOR MORE INFORMATION ON THIS OR OTHER INVESTIGATIONS AND CRIMINAL LITIGATION MATTERS, PLEASE CONTACT:

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