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This Week's Double Feature

Court to Government: Don't Tread on Attorneys' Fees

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The United States Court of Appeals for the Second Circuit dealt a severe blow to efforts by federal prosecutors to dissuade employers from paying attorneys' fees for indicted employees. The decision in *U.S. v. Stein*, No. 07-3042-cr, 2008 WL 3982104, at *1 (2d Cir. Aug. 28, 2008) sends a strong message to the government that the days of interfering with an employer's policy of advancing fees are now over. The court reached the extraordinary result of dismissing indictments against partners and employees of the KPMG accounting firm, and the decision may very well bring about the death of the so-called Thompson and McNulty Memoranda with respect to the issue of advancement of fees.

Stein involved former partners and employees of KPMG who were indicted for their alleged participation in tax fraud schemes carried out in the course of their duties for the firm. KPMG was also under investigation for its involvement in aggressive tax shelter arrangements. The accounting firm eventually avoided prosecution by entering into a deferred prosecution agreement with the United States Attorney's Office for the Southern District of New York, but not before refusing to pay for the partners' and employees' legal defense. The accounting firm was following a course of conduct that had become *de rigueur* in white collar investigations: show the government that you are a "good corporate citizen" by identifying employees who may be blameworthy, refuse to pay their legal fees, and then beg the government for mercy. In most instances, this strategy works like a charm, and indeed no substantial corporation or partnership has been indicted since the Arthur Andersen case.

The critical facts in *Stein* were not that unusual at all. During the tax shelter investigation, prosecutors signaled to KPMG's counsel that the advancement of fees for employees whom the government considered culpable would be looked upon unfavorably and would lead to the conclusion that the firm was not a good "cooperator." As a result, KPMG believed that the firm would be charged unless it disregarded its historic policy of advancing legal fees to all employees – whether or not they were targets of an investigation or under indictment. Government prosecutors were supposedly carrying out DOJ policies set forth in the so-called Thompson Memo (Mem. from Larry D. Thompson, Deputy Att'y Gen., U.S. Dep't of Justice, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003)), which allowed prosecutors to consider an entity's advancement of legal fees in deciding whether to bring criminal charges.

The Thompson Memo was widely criticized by defense lawyers as an impermissible interference with an employee's right to counsel and a well-founded corporate policy to attract and retain qualified employees by agreeing to pay for legal fees in connection with an investigation or prosecution. The Department of Justice later superseded the Thompson Memo with the McNulty Memo (Mem. from Paul J. McNulty, Deputy Att'y Gen., U.S. Dep't of Justice, *Principles of Federal Prosecution of Business Organizations* (Dec. 12, 2006)), which allowed prosecutors to consider the issue of advancement if it was intended to "impede a criminal investigation" – but otherwise left in place the linkage between payment of fees and possible indictment for a corporation.

Not surprisingly, KPMG agreed that it would not advance fees to anyone asserting a right to remain silent or who ended up being indicted. Once the government deemed an employee "uncooperative" (e.g., he or she did not provide a story consistent with the prosecutors' world view), the firm would immediately cut off attorney's fees. The firm also decided to "cap fees" for employees willing to play ball with the government. But for the government's threat to charge KPMG, KPMG would have followed its usual policy of advancing unlimited reasonable fees to all partners or employees requesting counsel regardless of their status as targets or indicted defendants. Needless to say, KPMG's decision was devastating to its loyal agents, who now faced the difficult decision of waiving their constitutional rights to silence or to trial, or else lose their counsel of choice in a complex and costly white-collar investigation.

After the government decided to pass on charging KPMG (in return for a substantial fine), prosecutors obtained indictments against several firm partners and employees. The KPMG defendants then moved for dismissal of the indictments based on due process and right to counsel grounds. The district court (by Judge Kaplan) agreed with the defendants' position and held that, among other things, prosecutors had deprived the defendants of their Sixth Amendment right to counsel of their own choosing. To say the least, the district court's decision was courageous and historic, and represented the first time a court took the government to task for interfering with an employer's good faith decision to advance legal fees to employees. The district court also acknowledged that in complex investigations few, if any, employees could afford private counsel unless the corporation agreed to pay the legal fees. After several procedural maneuvers below, Judge Kaplan eventually dismissed the indictments against the KPMG defendants as a result of the government's threatening conduct and adherence to the Thompson Memorandum. See *U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

The Second Circuit affirmed Judge Kaplan's decision and upheld the dismissal of the indictments. First, the court held that the close nexus between the actions of KPMG and the prosecutors constituted "state action" sufficient to invoke the protections of the Sixth Amendment right to counsel. The prosecutors' threats led directly to KPMG's denial of fees, which resulted in defendants' loss of their right to counsel of choice. As a result, for all intents and purposes, the actions of KPMG were

attributable directly to its government master. Next, the Second Circuit held that employees could reasonably expect that KPMG would have followed its usual policy to pay fees, except for the government's interference in the firm's usual decision-making process. The government's improper actions prior to indictment placed in context the Sixth Amendment violation, which ripened once the defendants were indicted and defendants' Sixth Amendment rights attached as a matter of law.

The court then articulated the core reasoning of its decision – the Sixth Amendment means little if the government can deprive a defendant of counsel of his or her own choice by interfering with an employer's good faith decision to advance fees. The Sixth Amendment thus prevents the government from preventing the use of legitimate funds to pay for counsel chosen by an indicted defendant. Because the court could find no remedy sufficient to restore the defendants to their rightful position before the constitutional violation, the Second Circuit dismissed the indictments.

Needless to say, the *Stein* decision represents a monumental shift in favor of preserving individual constitutional rights during a white-collar investigation and prosecution. No longer will the government be able to hold a sword over an employer's head and threaten the death penalty if a company decides to advance legal fees. Getting involved in fee issues, as the *Stein* facts make clear, is a messy business in any event, as prosecutors are well aware. Yet the Second Circuit's message to the government was made quite clear: stay away from interfering with an employer's good faith decision to advance legitimate legal fees or else risk losing the ultimate prosecutorial prize – a criminal indictment.

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