

PROTECTING EMPLOYEES' CONSTITUTIONAL RIGHTS IN GOVERNMENTAL INVESTIGATIONS: THE *U.S. v. STEIN* DECISIONS¹

On July 9, 2002, in response to various high profile corporate scandals, President Bush established a Corporate Fraud Task Force headed by then-Deputy Attorney General Larry Thompson. The Task Force created a memorandum entitled Principles of Federal Prosecution of Business Organizations (the "Thompson Memorandum"), which directed federal prosecutors to consider various factors when determining whether to indict a corporation. In particular, the Thompson Memorandum required prosecutors to consider a corporation's willingness to waive the attorney-client privilege and "a corporation's promise of support to culpable employees and agents, either through the advancing of attorneys' fees, [or] through retaining the employees without sanction for their misconduct."

From the outset, the Thompson Memorandum provoked controversy within the national legal community. Practitioners and state bar associations criticized its perceived interference with the attorney-client privilege and with a corporation's implementation of policies governing employee indemnification. The New York State Bar Association House of Delegates passed a resolution in June 2006 critical of the Memorandum's reward for corporations that decline to pay defense costs for their employees.

In *U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006) ("*Stein I*"), Judge Lewis Kaplan held that the Thompson Memorandum unconstitutionally coerced companies to deprive their employees of the means of defending themselves against criminal charges in violation of the Fifth and Sixth Amendments of the Constitution because it interfered with the rights of employees to receive a fair trial and to benefit from the effective assistance of counsel.

The *Stein* decision emerged amidst a backdrop of IRS and Senate Subcommittee investigations concerning the development and implementation of abusive tax shelters. KPMG found itself at the center of one such Senate Subcommittee investigation, and some of its partners were subpoenaed to testify in November of 2003. In response to that testimony, KPMG retained Skadden Arps to design a plan of cooperation with the government in an effort to avoid indictment.

Federal prosecutors investigating KPMG were keenly focused on whether KPMG planned to pay the legal fees of its employees under investigation. On more than one occasion during these discussions, the government referred to the Thompson Memorandum, and suggested that KPMG's payment of these fees would be viewed as rewarding misconduct. Judge Kaplan determined that the government's admonitions constituted a warning that "payment of legal fees by KPMG, beyond any that it might

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legally be obligated to pay, could well count against KPMG in the government's decision whether to indict the firm."

Judge Kaplan found that KPMG had in the past advanced and paid legal fees, without respect to a cap or condition of cooperation with the government, for its employees who found themselves having to defend civil, criminal or regulatory proceedings arising out of activities within the scope of their employment. He also found that, as a direct result of the government's coercion, KPMG had reversed this practice. KPMG's employees under investigation were instructed that KPMG would pay their legal fees and expenses, only up to \$400,000, and only on condition that the employee "cooperate with the government and . . . be prompt, complete, and truthful." Significantly, KPMG told these employees that "payment of . . . legal fees and expenses will cease immediately if . . . [the employee] is charged by the government with criminal wrongdoing."

Although each of the individual KPMG defendants in *Stein* subsequently made proffers to the government, the circumstances surrounding Defendant Smith was noteworthy. Acting upon the advice of counsel, Smith initially declined to make a statement about the tax shelters at issue. When the government reported Mr. Smith's lack of cooperation to KPMG, KPMG told Smith that unless he provided the government investigators with the information they requested, KPMG would cease payment of his legal fees and would possibly take further disciplinary action "including expulsion from the firm." Smith relented, rejected his attorney's advice, and agreed to make the proffer to save his job.

Judge Kaplan held that the government's implementation of the Thompson Memorandum coerced KPMG to eliminate payment of its employees' attorneys' fees, a benefit they would have otherwise received. This denial impinged upon the KPMG defendants' ability to defend themselves, and was thus constitutional only if it could survive strict scrutiny – if it were narrowly tailored to achieve a compelling objective. It did not, the Court held, because it "burdens excessively the constitutional rights of the individuals whose ability to defend themselves it impairs." In so holding, the Court noted that, if the government wanted to prohibit a corporation from rewarding employees engaged in the obstruction of justice, it could have easily achieved this goal by taking the payment of legal fees into account in making charging decisions only if such payments were part of an obstruction scheme. Accordingly, the Court held that the government's implementation of the Thompson Memorandum violated the KPMG defendants' Sixth Amendment right to counsel because the government "acted with the purpose of minimizing [their] access to the resources necessary to mount their defenses."

Shortly after *Stein I*, Judge Kaplan decided *U.S. v. Stein*, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) ("*Stein II*"), in which he suppressed the statements made by Defendant Smith and another KPMG partner on the ground that they were coerced by the government's implementation of the Thompson Memorandum. And, in September, the court also held that it had ancillary jurisdiction to hear claims by the KPMG employees against KPMG.

Stein shows that at least one prominent professional organization was prepared to sacrifice the rights of its employees to curry favor with prosecutors in an effort to avoid indictment. While *Stein* seems to protect employees whose companies have had longstanding practices of reimbursement for legal expenses, the fate of employees at companies without such policies remains unclear. If, however, *Stein's* underlying premise is to prevent the government from coercing corporations into sacrificing the constitutional protections of its employees, courts would be hard-pressed to distinguish between the two situations.