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U.S. v. Stein: Federal Prosecutors Twisting the Arm of Corporate America While Its Employees Cry Uncle (Sam)

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NOTES & COMMENTS

U.S. V. STEIN: FEDERAL PROSECUTORS TWISTING THE ARM OF CORPORATE AMERICA WHILE ITS EMPLOYEES CRY UNCLE (SAM)

I. INTRODUCTION

"The government ... has let its zeal get in the way of its judgment. It has violated the Constitution it is sworn to defend." This is the bold statement of Judge Lewis A. Kaplan, from the United States District Court for the Southern District of New York, in the June 26, 2006, U.S. v. Stein opinion. Kaplan delivered a scathing critique of federal prosecutors' interference with accounting giant KPMG's decision whether to advance

1. U.S. v. Stein, 435 F. Supp. 2d 330, 336 (S.D.N.Y. 2006). Subsequent to the writing of this casenote in the fall of 2006, the Stein litigation, as well as the federal government's approach to prosecuting corporations, has seen a tremendous amount of change. Given its inception date, this casenote obviously does not attempt to summarize or provide an updated commentary on the entire scope and progress of the Stein litigation or the changes in its wake—which admittedly, have been substantial. Instead, the casenote focuses solely on one piece of the litigation—now referred to as Stein I—and while "telling the story" of the case in detail, also uses the decision, in its contextual time frame, as a vehicle to introduce the argument that, given the societal importance of indemnification and advancement of legal fees (as evidenced in Stein), statutes providing for such benefits should be consistent for all business entities, regardless of form.

2. President Clinton nominated Judge Kaplan as a federal district court judge in 2004. Kaplan has presided over several high-profile cases in recent years "including all of the federal litigation involving the diabetes drug Rezulin; a price-fixing lawsuit against Sotheby's Holdings and Christie's International; and litigation surrounding the collapse of Parmalat SpA." He is known as being "gruff and sarcastic" and is not afraid of challenging attorneys' preparedness when they step into his courtroom. One of Kaplan's former law clerks stated that the judge "pays profound and extraordinary attention to the facts in every case." Kaplan also has a history of standing up to the government. In a 1997 case involving a Peruvian citizen who had been kept in custody despite a ruling in his favor by an immigration judge, Kaplan chided prosecutors and the U.S. Immigration and Naturalization Service for their conduct. Paul Davies, Bench on Fire: KPMG Judge Grills Prosecutors, Wall St. J. B1 (Aug. 5, 2006).


4. KPMG (as it is commonly referred to) is the product of a 1987 merger of the accounting firms Peat Marwick International (PMI) and Klynveld Main Goerdeler (KMG). The firm provides audit, tax, and advisory services on a global basis. KPMG International is a Swiss cooperative that provides the network for its independent member firms from around the world. In 2005, the cooperative included member firms in 144 countries that employed 104,000 people and produced composite revenue of $15.69 billion. KPMG Int'l., About KPMG, http://www.kpmg.com/About/ (accessed Nov. 3, 2006). KPMG LLP, the entity implicated in Stein, is a U.S. based limited liability partnership and is a member of the KPMG International network of independent member firms. The U.S. entity's headquarters is in New York City, New York, and their total revenues for the 2005 fiscal year ending on September 30, 2005, were approximately $4.7 billion. In 2005, KPMG LLP employed 19,600 people spread across 93 different U.S. office locations, including approximately 1,600 partners, 13,200 "client service professionals," and 4,800 "client service support" associates. KPMG
legal fees to former employees implicated in the largest criminal tax case ever filed. According to Kaplan's detailed analysis, KPMG deviated from its routine practice of paying legal fees to the involved employees because of government pressure on the company to secure "cooperator" status with prosecutors. "KPMG refused to pay because the government held the proverbial gun to its head." Kaplan held that but for the government's coercive methods, the firm would not have abandoned its well-established track record of paying the legal fees and expenses of its employees.

Faced with the prospect of indictment as an entity for its own role in the criminal tax controversy and a similar fate as its old accounting rival Arthur Anderson, KPMG succumbed to the government's overbearing pressure tactics and effectively left its employees out in the cold. In the opinion, Kaplan points to the explicit mandatory prosecution guidelines found in a controversial Department of Justice memorandum and the aggressive tactics of the U.S. attorneys handling the case, as the two primary sources of government pressure. In essence, a prosecutorial one-two punch that led Kaplan to respond with a knockout blow of his own in the form of holding the government's actions unconstitutional. The decision represents the first major judicial attack on federal prosecution tactics implemented to retaliate against the plethora of corporate accounting scandals experienced by the American economic sector in recent years.

In a forty-eight page opinion issued in response to a motion submitted by the KPMG defendants to dismiss their indictments due to government violations of their constitutional rights, Judge Kaplan directly addresses the nature of indemnification and advancement of legal fees. He refers to indemnification of legal fees as a "principle of American law" and while "not of constitutional dimension," it is "very much a part of
American life.”18 He clearly states, “This right is as much a part of the bargain between employer and employee as salary or wages.”19 Kaplan’s succinct description of the “principle” is this: “[A]n employer often must reimburse an employee for legal expenses when the employee is sued, or even charged with a crime, as a result of doing his or her job.”20 Regarding the nature of advancement of legal fees, Kaplan’s view is that “the employer often must advance legal expenses to an employee up front, although the employee sometimes must pay the employer back if the employee has been guilty of wrongdoing.”21

Judge Kaplan evidences his sincere recognition of the “principles” of indemnification and advancement by fashioning two primary remedies in Stein designed to restore the defendants “to the position they would have occupied had the government not interfered improperly with their prospects for advancement of defense costs.”22 This casenote examines the remedies Kaplan proposes in Stein but primarily focuses on and supports one remedy in particular. By combining Delaware partnership and corporation law on indemnification and advancement of legal fees,23 Kaplan provides the KPMG defendants with a mechanism known as a “summary advancement proceeding” to seek their desired legal expenses in an expeditious manner.24 This casenote applauds Kaplan’s creative use of two different sources of Delaware business entity law to formulate such a remedy, and closely examines how this remedy was constructed. As a corollary topic, the casenote will also address the Delaware partnership law governing KPMG in regards to indemnification,25 and offer a public policy argument that its provisions should expressly provide for advancement of legal fees along with an avenue to resolve conflicts over indemnification similar to that of the Delaware corporation law.26

Before an examination of the remedies proffered in Stein can be undertaken, it is essential to understand the facts and environment preceding the litigation that spawned the eventual violations of the KPMG employees’ constitutional rights and provided cause for Judge Kaplan to issue such remedies. Accordingly, Part II of the casenote describes the political context surrounding Stein. This background specifically includes an examination of the evolution of the Justice Department’s formal guidelines for the prosecution of corporations. Part III articulates the specific factual circumstances of Stein, employing a predominately sequential approach. Also included in this section is a restatement of Judge Kaplan’s “ultimate factual conclusions”27 as well as a brief summary of his legal holdings and the reasoning behind them.28

18. Id.
19. Id.
20. Id.
21. Id.
28. See id. at 353-73.
Part IV addresses the analytical framework of the above stated thesis by delving further into the court’s proposed remedies, paying special attention and providing support to the “summary advancement proceeding”\textsuperscript{29} and the inventive creation and mechanics behind this particular remedy. A brief, general discussion of indemnification and advancement of legal fees precedes the thesis analysis, providing a necessary foundation to comprehend the court’s approach to remediying the government’s violation of the KPMG employees’ constitutional rights. Finally, Part V highlights the issues brought to the forefront by Stein, the resolution of which will certainly have an impact on the state of not only the advancement of legal fees, but also on the post-Enron approach employed by federal prosecutors against American businesses.

II. BACKGROUND

A. The Evolution of Justice Department Guidelines for Corporate Prosecution

Fully understanding the court’s criticism of the government’s prosecution tactics in \textit{U.S. v. Stein}\textsuperscript{30} requires an analysis of the history of the Department of Justice’s development of guidelines for prosecuting business entities. Preceding the existence of the Thompson Memorandum\textsuperscript{31} (the government memo providing the fuel for the Stein holding) a document entitled \textit{Federal Prosecution of Corporations}\textsuperscript{32} established the initial Department of Justice guidelines addressing the charging of corporations.\textsuperscript{33} The memorandum was drafted by then U.S. Deputy Attorney General Eric Holder\textsuperscript{34} in June 1999, and assisted government prosecutors in deciding whether to charge corporations, rather than individuals, with criminal wrongdoing.\textsuperscript{35} Prior to the issuance of the “Holder Memo,”\textsuperscript{36} the Justice Department lacked a standardized policy addressing the prosecution of corporations.\textsuperscript{37}

In a letter attached to the \textit{Federal Prosecution of Corporations} and directed to “All Component Heads and United States Attorneys,” Deputy Attorney General Holder made it expressly clear that the new factors were “not outcome-determinative and [were] only

\begin{itemize}
  \item \textsuperscript{29} \textit{Id.} at 379–80.
  \item \textsuperscript{30} 435 F. Supp. 2d 330.
  \item \textsuperscript{31} Dept. Just., \textit{Federal Prosecution of Business Organizations}, http://www.justice.gov/dag/cftf/corporate_guidelines.htm (accessed Sept. 10, 2006). This document is commonly referred to as the “Thompson Memorandum” due to the fact it was drafted by then Deputy Attorney General, Larry D. Thompson. \textit{Id.}
  \item \textsuperscript{34} Mr. Holder was appointed in 1997 by President Clinton to the Deputy Attorney General post. The Deputy Attorney General is the second highest ranking position in the Department of Justice, and Mr. Holder was the first African-American to serve in that capacity. He also had a brief stint as the Acting Attorney General during the confirmation process of Attorney General John Ashcroft. Covington & Burling LLP, \textit{Professionals}, http://www.cov.com/lawyers/eholder/biography.html (accessed Sept. 10, 2006).
  \item \textsuperscript{35} \textit{Stein}, 435 F. Supp. 2d at 336.
  \item \textsuperscript{36} The memorandum \textit{Federal Prosecution of Corporations} is also known as the “Holder Memo,” given the fact that then Deputy Attorney General Holder was responsible for its drafting. Wray & Hur, \textit{supra} n. 33, at 1099.
\end{itemize}
guidelines.” He also made it clear that federal prosecutors were under no obligation to utilize the suggested factors, nor was it necessary to make note of the importance they attributed to individual factors in determining the culpability of a company in a given case. Despite the fact that the Holder Memo was only a purely discretionary tool for prosecutors, the content of the document is one of the primary sources Judge Kaplan relies on in the Stein opinion.

As well as identifying some “common sense considerations” in the determination of whether to formally charge a corporation, the Holder Memo expressly provided one particular section of factors that eventually formed the foundation of the dispute in Stein. This section was entitled “Charging the Corporation: Cooperation and Voluntary Disclosure,” and suggested that part of a government prosecutor’s evaluation should include the consideration of a company’s “timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents.” This analysis of an entity’s readiness to cooperate in the investigation could also factor in, if necessary, a company’s “waiver of the corporate attorney-client and work product privileges.” Section VI of the memo described in further detail the meaning of cooperation as the “willingness to identify the culprits within the corporation, including senior executives, to make witnesses available, [and] to disclose the complete results of its internal investigation . . . .” The section then included several paragraphs of commentary, one of which contained the precise framework for the primary conflict in Stein:

Another factor to be weighed by the prosecutor is whether the corporation appears to be protecting its culpable employees and agents. . . . [A] corporation’s promise of support to culpable employees and agents, either through the advancing of attorneys fees, through retaining the employees without sanction for their misconduct, or through providing information to the employees about the government’s investigation pursuant to a joint defense agreement, may be considered by the prosecutor in weighing the extent and value of a corporation’s cooperation.

Central to the principle issue in Stein is the aforementioned statement concerning the advancement of attorneys fees. A footnote to the legal fees comment did recognize the fact that some states by statute require corporations to pay the legal costs of officers (prior to a conviction), which clearly would not render a company being defined as

38. Dept. Just., supra n. 32.
39. Id.
41. Id. at 336. Among the “common sense considerations” prosecutors were instructed to take note of were “the nature and seriousness of the offense, the pervasiveness of wrongdoing within the entity, the company’s efforts to remedy past misconduct, the adequacy of other remedies” as well as other similarly related inquiries. Id.
42. Id. at 337.
43. Dept. Just., supra n. 32, at § VI.
44. Id. at § II(A)(4).
45. Id.
46. Id. at § VI(A).
47. Id. at § VI(B) (emphasis added) (internal citation omitted).
uncooperative, since they simply would be adhering to the controlling law of their respective state.49 As a result, it is possible to deduce from the text of the Holder Memo that a company under investigation by the federal government, who does not have a legal duty to advance fees, could potentially be viewed as not “cooperating” if they engaged in the practice of forwarding fees to a “culpable” employee at their own discretion.50 This is the precise understanding and view of the language in the Holder Memo as interpreted by Judge Kaplan51 and this logic becomes vitally important when viewed in the context of the conflict of interests between KPMG and the defendants in Stein.52

B. The Inherently Threatening “Thompson Memorandum”53

Federal prosecutors’ discretion in adhering to the guidelines set forth in the Holder Memo was briskly terminated when a wave of corporate scandals rocked the nation just two short years after the memo’s issuance.54 A number of large corporations fell victim to their own corrupt and fraudulent practices, highlighted by the massive implosion of energy stalwart Enron in 2001.55 Also involved in the corporate scandals was Arthur Anderson, the auditor for Enron and major competitor of KPMG.56 Arthur Anderson was indicted by the federal government for their role in the Enron debacle, and as a result of the indictment, the firm collapsed prior to the case being tried.57 The fate of Arthur Anderson would no doubt cast a dark shadow in KPMG’s conscience when they too would face the imminent possibility of a federal indictment.58

In 2002, as one part of a reply to the plethora of corporate scandals,59 President Bush developed a corporate fraud task force, led by a new Deputy Attorney General, Larry D. Thompson.60 In the backdrop of the corporate fallout of the previous two years, Thompson and Justice Department officials conducted an analysis of the Holder Memo and in January 2003 issued a new Department document entitled Principles of Federal Prosecution of Business Organizations,61 which was quickly coined the “Thompson Memo.”62 The Thompson Memo was essentially a slight alteration of the Holder Memo with many of the provisions actually left unchanged.63 In particular, the

49. Dept. Just., supra n. 32, at n. 3.
50. Stein, 435 F. Supp. 2d at 337.
51. Id.
52. Id. at 330.
53. Id. at 352.
54. Wray & Hur, supra n. 33, at 1100.
55. Stein, 435 F. Supp. 2d at 337. Also included in the 2001 corporate collapse were Adelphia Communications, Global Crossing, HealthSouth, ImClone, Tyco International, and WorldCom, among others. Id.; Wray & Hur, supra n. 33, at 1100.
56. Stein, 435 F. Supp. 2d at 337.
57. Id.
58. Id. at 341.
60. Stein, 435 F. Supp. 2d at 337.
62. Wray & Hur, supra n. 33, at 1101.
language pertaining to the advancement of legal fees and corporate cooperation remained identical.\textsuperscript{64}

The influential characteristic of the Thompson Memo that clearly distinguished it from its precursor was that all federal prosecutors were now \textit{obligated} to abide by the tenets of the document when considering the prosecution of a business entity.\textsuperscript{65} This change meant that if a company wished to abide by their long-standing policy of advancing legal fees to its employees charged with criminal conduct in the course of their job, federal prosecutors \textit{must} view this as possible uncooperative action and as a "factor weighing in favor of the indictment of the entity."\textsuperscript{66} Considering the impact of the indictment on Arthur Anderson, it is clear that under the Thompson Memo it would be a huge mistake for a company in the government's crosshairs not to cooperate at all costs with prosecutors, even if that meant abandoning a well-established company practice.\textsuperscript{67}

This amplified focus on corporate cooperation with government prosecutors is best articulated in the introductory portion of the Thompson Memo, which states that "the main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation."\textsuperscript{68} The preface to the revised guidelines directs prosecutors to determine if a company is truly cooperating with the government, or acting to interfere with the "quick and effective exposure of the complete scope of wrongdoing."\textsuperscript{69} Is it then a logical conclusion for corporate counsel to assume that the discretionary advancement of legal fees to "culpable employees" equates to an interference with the "quick and effective exposure" of a criminal investigation?\textsuperscript{70} This is just one of the issues so delicately framed in \textit{Stein}, a case that demonstrates the extent to which a company under federal investigation will go to earn the precious status of "cooperator" in order to avoid the death knell of a federal indictment.\textsuperscript{71} Consequently, the actions of the corporation in cooperating with the Thompson Memo are not without a reaction, which in \textit{Stein} is represented by the indicted employees' loss of legal assistance provided by the company.\textsuperscript{72}

\section*{III. STATEMENT OF THE CASE}

\subsection*{A. KPMG Enters the Government's Radar}

During the development of the Thompson Memo, the Internal Revenue Service (IRS) began investigating tax shelters large accounting firms were creating and marketing to wealthy individuals.\textsuperscript{73} Included in this investigation were a number of

\begin{thebibliography}{9}
\bibitem{64} Id.
\bibitem{65} Id.
\bibitem{66} Id.
\bibitem{67} Pickholz & Pickholz, supra n. 7.
\bibitem{68} Dept. Just., supra n. 31.
\bibitem{69} Id.
\bibitem{70} Id.
\bibitem{71} Stein, 435 F. Supp. 2d 330.
\bibitem{72} Id.
\bibitem{73} Laurie P. Cohen, \textit{In the Crossfire: Prosecutors' Tough New Tactics Turn Firms against Employees; As}
\end{thebibliography}
shelters that allegedly implicated the defendants centrally involved in Stein. The tax shelters under investigation were intricate transactions designed to mitigate affluent participants’ tax obligations. For example, KPMG advised certain clients to create shell companies and execute large loans in proceedings that generated significant tax savings. This practice divided the partners at KPMG, with some believing the firm had an obligation to register the shelters with the IRS, while others claimed it was not necessary for the firm to bring the shelters to the attention of the agency. KPMG ultimately decided not to register the shelters and instead embarked on a course of actively selling the products. This decision ultimately drew the focus of the IRS though, and in early 2002, the agency issued nine summonses to KPMG related to its aggressive tax shelter program.

In late 2002, a Senate Committee on Governmental Affairs initiated a general inquiry into the “development, marketing, and implementation of abusive tax shelters by accountants, lawyers, financial advisors, and bankers.” In November 2003, the investigation led to public hearings where a group of current and former KPMG partners testified. KPMG was the focus of much of the senate committee’s inquiry, due in part to the firm’s strong defense of the shelters it had designed and sold. In the course of the inquiry, the committee discovered that KPMG had collected approximately $124 million in fees generated from the sale of tax shelters to roughly 350 individuals from 1997 to 2001.

To lead the defense of KPMG’s practices before the Senate committee, the firm turned to Jeffrey Eischeid, a tax partner in charge of personal-financial planning. While Eischeid was not involved in the development of the shelters, he was responsible for ushering two of the shelters through the firm’s internal approval process and marketing them. Eischeid’s testimony to the committee did not produce the type of results KPMG desired though. At one critical point in the hearings, Senator Carl Levin pressured Eischeid to admit that the primary purpose of the shelters was to assist individuals in the evasion of taxes. When Eischeid disagreed by insisting that the shelters also had an investment function, Senator Levin responded by reading aloud an email written by Eischeid describing a particular tax shelter as being “designed to

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74. Stein, 435 F. Supp. 2d at 338.
75. Cohen, supra n. 73.
76. Id.
77. Id.
78. Id.
80. Id.
81. Id.
82. Cohen, supra n. 73.
83. Id.
84. Id.
85. Id.
86. Id.
87. Senator Levin was the ranking minority member on the committee. Cohen, supra n. 73.
88. Id.
mitigate an individual’s income tax, as well as estate and gift tax burdens.”

Struggling to respond with an appropriate reply in the face of such conflicting testimony, Eischeid told Senator Levin that he did not know how to “change [his] answer,” to which the Senator then suggested “[W]ell, try an honest answer.”

B. Spring Cleaning at KPMG

As a result of the less than stellar showing at the Senate hearings and the initiation of IRS proceedings, KPMG decided that significant changes were necessary to improve the firm’s future prospects. Their first move was to make major changes pertaining to the firm’s outside counsel. After the Senate hearings, KPMG fired Willkie Farr & Gallagher LLP, the law firm responsible for assisting them with their unsuccessful performance in front of the committee. King & Spalding LLP, the law firm responsible for KPMG’s representation before the IRS, was also relieved from their duties. KPMG then retained the law firm of Skadden Arps Slate Meagher & Flom (Skadden) to help the firm develop a new “cooperative approach.”

This new approach involved “clean[ing] house,” which consisted of three KPMG partners who participated in the senate hearings (and who are now defendants in Stein) being asked to leave their jobs with the firm. One of the dismissed employees, Jeffrey M. Stein, was the “deputy chair and chief operating officer” for the company. Stein had been responsible for managing the “development and approval of the tax shelters.”

Due to Stein’s position in the firm, the company gave him a “retirement” package, which included a three-year, $100,000 per month “consulting agreement,” as well as an understanding that KPMG would provide legal representation of his choice for any litigation founded on his actions as an employee.

Another person asked to leave their position was Jeffrey Eisheid, the tax partner who led the defense of KPMG in the Senate proceedings. KPMG initially placed Mr. Eisheid on administrative leave, however, the firm later sought and obtained his resignation. Richard H. Smith, Jr., vice chairman of tax services, was the third

89. Id.
90. Id.; Stein, 435 F. Supp. 2d at 339.
92. Cohen, supra n. 73.
93. Id.
94. Id.
95. Skadden is widely recognized as the top corporate law firm in the United States. This popular distinction was recently confirmed by Corporate Board Member magazine, who conducted an extensive survey of 1,483 directors and 284 general counsel of publicly traded companies. Skadden was placed at the top of both the directors’ and general counsels’ lists as the firm they would most want to represent their company on a national matter. Corp. Bd. Member Mag., Directors and General Counsel Rank Best Corporate Law Firms in America, Skadden Arps Tops List for the Fifth Straight Year, http://www.boardmember.com/about_us/release_061305.shtml (accessed Oct. 8, 2006).
97. Id. at 339.
98. Id.
99. Cohen, supra n. 73.
100. Stein, 435 F. Supp. 2d at 339.
101. Cohen, supra n. 73.
102. Id.
partner forced out of his position with the firm when he was internally reassigned. After completing the aforementioned personnel changes, KPMG claimed the moves “reaffirm[ed] KPMG’s commitment to the highest standards of professional practice and responsibility.”

In spite of KPMG’s self-proclaimed re-dedication to professional ethics, a great deal of damage had already been inflicted to the firm’s image and good standing with the government. This harm was finally realized when in early 2004, “the IRS made a criminal referral to the Department of Justice concerning KPMG’s alleged involvement in the design and marketing of illegal tax shelters. The Department of Justice passed the referral to the United States Attorney’s Office for the Southern District of New York, finalizing both the forum and parties involved in Stein.

C. “The Meeting”

On February 5, 2004, the U.S. attorney’s office contacted Skadden regarding the criminal referral from the Internal Revenue Service and scheduled an initial meeting for February 25, 2004. As part of the U.S. attorneys’ preparation for the meeting, they drafted a document called “Skadden Meeting Points,” articulating specific issues they wanted to pursue. On the first page was an item that posed the questions: “Is KPMG paying/going to pay the legal fees of employees? Current or former? Any agreements or other obligations to do so? What are they?” This specific reference to an initial inquiry concerning the payment of legal fees provides one overt example of the government’s significant interest in the topic.

At the meeting on February 25, 2004, the lead attorney representing Skadden was Robert S. Bennett. Bennett is a high-profile trial lawyer who has been involved in the corporate defense of both Enron and HealthSouth. He also represented President Clinton in the Paula Jones case and Judith Miller in the recent CIA leak investigation. Bennett’s services were specifically sought out by then KPMG chair, Eugene O’Kelly, after the unfavorable senate hearings involving the firm’s partners.

Bennett had developed a stellar reputation as cooperatively working with federal
prosecutors in corporate defense cases. During Bennett’s defense work on the HealthSouth case, the U.S. attorney in Birmingham said she “found him a pleasure to work with.” This adulation possibly resulted from Bennett’s quick work there “to make documents and witnesses available to prosecutors.” He also is very aware of the effects that an indictment can have on a company’s future, as evidenced by his comment that an indictment of HealthSouth “would risk putting 40,000 people out of work.” Clearly, KPMG had found the attorney who could understand their predicament and the potentially devastating consequences should the firm suffer an indictment as an entity for criminal wrongdoing.

Headlining the government’s representation at the meeting was the chief counsel to the U.S. Attorney for the Southern District of New York, Shirah Neiman. Neiman was a contributor to the Holder Memo and was the U.S. attorney’s office liaison to the Internal Revenue Service. She also was the supervising attorney handling the criminal referral initiated by the IRS involving KPMG. Both sides were represented by additional counsel, including Assistant U.S. Attorney Weddle, who started the meeting by telling Skadden the government was interested in hearing their comments and had a few follow-up questions as well.

Bennett informed the government of KPMG’s self-initiated decision to “clean house” and “change the atmosphere at the firm.” He also mentioned that KPMG was willing to fully cooperate with the government’s inquiry, and in a clear reference to Arthur Anderson’s collapse, stated that the goal was to “save KPMG” and not to shield any individual employees. After some other preliminary conversation between the two sides, Weddle brought up the topic of legal fees and inquired as to whether KPMG had any duty to pay the fees of its employees. In an effort to “test the waters,” Bennett asked for the government’s take on the subject. Neiman fielded the question and informed Skadden that the government would take into consideration any legal obligations to pay fees, but specifically referenced the Thompson Memo as “a point that had to be considered.”

In response, Skadden explained KPMG’s “common practice” in the past had been to take care of legal expenses for employees. Skadden further stated that KPMG’s partnership agreement was unclear on the topic and that the controlling Delaware

117. Cohen, supra n. 73.
118. Id.
119. Id.
120. Id.
122. Id.
123. Id.
124. Id. at 341.
125. Id.
127. Id.
128. Id.
129. Id.
130. Id. at 342.
statute\textsuperscript{131} allowed the company to do as it pleased, however, they were still fully analyzing the firm's legal duties.\textsuperscript{132} Then, in an obvious ploy to favorably position itself with the government's prosecution objectives, Skadden announced that KPMG would no longer pay the legal fees of employees who refused to cooperate with the government or who invoked their Fifth Amendment constitutional right against self-incrimination.\textsuperscript{133}

Both sides then momentarily moved on to discussing other topics, but Weddle quickly circled back around to the fees issue and once again asked Bennett to ascertain KPMG's duties relating to the matter.\textsuperscript{134} Immediately after this inquiry regarding payment of legal fees by Weddle, Neiman stated that, "misconduct should not or cannot be rewarded" and then mentioned "federal guidelines."\textsuperscript{135} Given the context surrounding this comment by Neiman, it is easy to understand how the court in \textit{Stein} found that it was reasonable for both Skadden and the prosecutors to understand her statement as a not so subtle "reminder."\textsuperscript{136} A "reminder" that if a company advances legal fees to an employee under investigation, where they have no legal obligation to do so, under the Thompson Memo the action would be viewed as "uncooperative" thus subjecting the company to a potential indictment.\textsuperscript{137}

Just in case the true meaning of the remark from Neiman was not clear enough though, Weddle followed up her comment by telling Skadden that "if you have discretion re[garding] fees, we’ll look at that under a microscope."\textsuperscript{138} While Neiman would later argue to the court that she was not referring to the legal fee issue with her "reward" comment,\textsuperscript{139} Weddle’s unambiguous message certainly provides contradictory evidence to her claim.\textsuperscript{140} As a result of Neiman’s comment and the follow-up statement by Weddle, Judge Kaplan concluded in \textit{Stein} that while the U.S. attorneys handling the case did not explicitly tell Skadden that KPMG should refrain from paying the legal fees of its employees, no party present at the meeting could have understood the government’s message as communicating anything to the contrary.\textsuperscript{141}

D. KPMG's (Successful) Quest to Satisfy the Government's Definition of Cooperation

After Skadden's meeting with the U.S. attorneys on February 25, 2004, KPMG (aided by the counsel of Skadden) began a series of maneuvers designed to satisfy the

\textsuperscript{131} Del. Code Ann. tit. 6, § 15-110.
\textsuperscript{132} \textit{Stein}, 435 F. Supp. 2d at 342.
\textsuperscript{133} Id.
\textsuperscript{134} Id.
\textsuperscript{135} Id.
\textsuperscript{136} Id. at 344.
\textsuperscript{137} \textit{Stein}, 435 F. Supp. 2d at 343-44.
\textsuperscript{138} Id. at 344. Mr. Weddle's statement was recorded by Mr. Pilchen, an attorney for Skadden. Although the comment by Mr. Weddle only appeared in Mr. Pilchen's notes of the meeting and no person present at the meeting could recall the comment being said, the court upheld the evidential integrity of the quote. The court emphasized the fact that Mr. Pilchen's notes specifically attributed the comment to Mr. Weddle, that "memorable language" was used, and that the remark was clearly underlined in Mr. Pilchen's notes. Id. at 344 n. 52.
\textsuperscript{139} Id. at 342.
\textsuperscript{140} Id. at 344.
government’s definition of cooperation as laid out in the Thompson Memo and in the firm’s subjective perceptions of the federal prosecutors’ expectations. The first example of cooperative behavior was Bennett’s follow-up with Weddle regarding the legal fee question. He informed Weddle that they did not believe KPMG had any legal obligation to pay fees, but since the firm was a partnership, “it would be a big problem” to not pay them. Bennett mentioned that KPMG was thinking about still paying fees, but conditioning the receipt of such fees on a partner or employee “cooperating fully with the company and the government,” and also putting a “cap” or “limit” on the total amount of fees the company would pay. The U.S. attorneys accepted KPMG’s legal conclusion and plans on the fee issue without looking into the situation further.

On March 11, 2004, Skadden forwarded a letter to prosecutors they were preparing to send out to all KPMG employees who were suspected of being involved in the government’s criminal investigation of the firm. In the letter, Skadden detailed KPMG’s new policy pertaining to the advancement of legal fees. The policy stated that KPMG would pay an employee’s legal fees up to $400,000, conditioned on that individual cooperating with the government and being “prompt, complete, and truthful.” It also mentioned that the payment of fees would “cease immediately” if the employee is “charged by the government with criminal wrongdoing.” After learning of KPMG’s newly implemented policy on the advancement of legal fees, the U.S. attorneys had no objections with the firm’s “self-imposed” guidelines.

Prosecutors did take issue though, with an “advisory memorandum” that Joseph Loonan, then KPMG deputy general counsel, sent to firm employees addressing “potential contacts by the government.” While the memo suggested employees fully cooperate with the government investigation, it also mentioned that employees had a right to an attorney in their interaction with prosecutors, the benefits associated with

142. Dept. Just., supra n. 31, at § VI.
143. Stein, 435 F. Supp. 2d at 344-47.
144. Id. at 344.
145. Id. at 344-45.
146. Id. at 345.
147. Id. at 344-45 n. 54. This failure by the prosecutors to not probe further into KPMG’s legal duty to provide fees deeply troubled the court. Judge Kaplan’s view was that the firm had a strong interest in concluding they did not have a legal obligation to pay fees so they could avoid any possible conflict with the related provisions of the Thompson Memo or with the prosecutors’ already clear message on the subject. The court felt that the prosecutors should have been aware of this blatant conflict between KPMG’s interests and its employees’ interests, and looked into the matter firsthand to make an unbiased determination on the subject. Instead, all the prosecutors did was request a copy of KPMG’s partnership agreement and by-laws which they may or may not have actually read. The government also did not question the practice of Skadden recommending as counsel to KPMG employees “law firms that were familiar with these types of proceedings and who understood that cooperation with the government was the best way to proceed . . . it was not necessarily best for its employees.” Stein, 435 F. Supp. 2d at 344-45 n. 54.
148. Id. at 345.
149. Id.
150. Id.
151. Id. at 345-46.
152. Stein, 435 F. Supp. 2d at 346.
153. Id.
representation by counsel, and that KPMG would be providing "independent counsel" for those who were interested.\textsuperscript{154} The prosecutors were "upset" about the memorandum's content and promptly told Skadden they were "disappointed with [its] tone" and "one-sided presentation of potential issues" and insisted that KPMG reissue a new memorandum including revisions suggested by the prosecutors.\textsuperscript{155}

The only difference between the revised memorandum suggested by the government and the original memorandum drafted by Loonan, was that the government wanted the document to explicitly mention that KPMG employees had the option to "meet with investigators without the assistance of counsel."\textsuperscript{156} At first, Bennett challenged the government's demand to change the memorandum, pointing to past examples where he had sent out documents very similar to the one Loonan had drafted without objection by prosecutors.\textsuperscript{157} Bennett also re-emphasized to the government the extreme change KPMG had implemented in its policy addressing the payment of legal fees.\textsuperscript{158} In the end, however, KPMG succumbed to the government pressure to cooperate and subsequently issued a revised memorandum to employees with the prosecutors' suggested alterations.\textsuperscript{159} According to the court in \textit{Stein}, the government's motive in insisting on the revision to the employee memorandum was to improve the odds that KPMG employees would consent to government meetings absent consultation with an attorney either before or during an interview.\textsuperscript{160}

In yet another obvious ploy to display KPMG's willingness to cooperate with the government, the firm asked the U.S. attorneys to "notify [them] if any current or former KPMG employee refused to meet with prosecutors or otherwise failed to cooperate."\textsuperscript{161} The prosecutors handling the investigation seized this invitation from KPMG and frequently brought to Skadden's attention examples of KPMG employees refusing to conform to government demands.\textsuperscript{162} Skadden responded to these "tips" by contacting the lawyer for the employee in question and informing them that "absent an indication from the government within the next ten business days that your client no longer refuses to participate in an interview with the government," the payment of the employee's legal fees and expenses would be canceled.\textsuperscript{163} This heavy-handed approach ultimately resulted in some KPMG employees submitting to the "pressure of the threats" and re-aligning their efforts in the investigation to the government's standards.\textsuperscript{164} Other KPMG employees, however, exhibited a more defiant stance under the circumstances and were

\textsuperscript{154.} \textit{Id.}
\textsuperscript{155.} \textit{Id.}
\textsuperscript{156.} \textit{Id.}
\textsuperscript{157.} \textit{Stein}, 435 F. Supp. 2d at 346 n. 66.
\textsuperscript{158.} \textit{Id.}
\textsuperscript{159.} \textit{Id.} at 346. KPMG ultimately sent out a new memorandum to employees in a "Q & A format" that provided a "more balanced approach" according to Mr. Bennett. The "question" on the revised memorandum to employees that satisfied the government's concerns was "Do I have to be assisted by a lawyer?" This question was then answered with a response of "No," and that the employees could "deal directly with government representatives without counsel." \textit{Id.} at 346 n. 66.
\textsuperscript{160.} \textit{Id.} at 347.
\textsuperscript{161.} \textit{Stein}, 435 F. Supp. 2d at 347.
\textsuperscript{162.} \textit{Id.}
\textsuperscript{163.} \textit{Id.}
\textsuperscript{164.} \textit{Id.}
promptly rewarded for their actions by having their employment terminated and the payment of their legal fees cancelled.\textsuperscript{165}

One final illuminating example of KPMG's unwavering cooperation with the government was the firm's response to what the court referred to as the "Stein problem."\textsuperscript{166} The Stein problem referred to two sources of conflict associated with the large "retirement" package KPMG extended to its former "deputy chair and chief operating officer," Jeffrey M. Stein.\textsuperscript{167} The first source of conflict was the head of the criminal division of the U.S. Attorney's Office, Karen Seymour, disclosing to KPMG that she was aware that the firm had "granted rich severance packages to certain executives."\textsuperscript{168} Seymour stated that the practice introduced a "troubling issue under the Thompson Memo."\textsuperscript{169} In an effort to sidestep this point, Skadden reminded the government of their new policy on legal fees, which included capping the payment of fees at $400,000 and conditioning receipt of fees on full cooperation with prosecutors.\textsuperscript{170}

Skadden's attempt to mitigate the excessive nature of Stein's severance package by mentioning the cap placed on the payment of legal fees actually created the second source of conflict concerning KPMG's retirement deal with Stein.\textsuperscript{171} That conflict was the fact that KPMG had already paid over $646,000 in legal fees on Stein's behalf, which was an obvious violation of the standards the firm had set to garner "cooperator" status with the government and increase their chances of escaping indictment as an entity.\textsuperscript{172} After David N. Kelley, then U.S. Attorney, told Skadden that in regards to KPMG's cooperation efforts he had "seen a lot better from big companies," KPMG decided that the "Stein situation" was too flammable to ignore and decided to take action on the matter.\textsuperscript{173} Eight days before KPMG was scheduled to meet with the U.S. Deputy Attorney General to discuss their case, the firm terminated both the consulting segment of Stein's package and the payment of his legal fees.\textsuperscript{174} According to Loonan, KPMG's deputy general counsel, the firm took these steps "because [we] thought it would help [us] with the government."\textsuperscript{175}

On June 13, 2005, Skadden and KPMG met with then Deputy Attorney General James Comey to make their case against indicting the accounting firm for criminal conduct associated with the allegedly illegal tax shelters.\textsuperscript{176} Leading the way at the meeting for KPMG was Bennett, whose argument to Comey heavily relied on the drastic measures KPMG had taken in order to meet the government's expectations of

\begin{footnotes}
\item[165.] Id.
\item[166.] Stein, 435 F. Supp. 2d at 347.
\item[167.] Id. at 339, 347-48.
\item[168.] Id. at 347.
\item[169.] Id.
\item[170.] Id.
\item[171.] Stein, 435 F. Supp. 2d at 347-48.
\item[172.] Id. at 348 n. 74.
\item[173.] Id. at 348.
\item[174.] Id.
\item[175.] Id. Loonan further stated that "wanting to have the government believe we were cooperating with them was one of the reasons" the company sent a letter to Stein notifying him of KPMG's decision to cease paying his legal expenses. Justice in the Dock, Wall St. J. A14 (June 6, 2006).
\item[176.] Stein, 435 F. Supp. 2d at 348.
\end{footnotes}
Bennett specifically mentioned that KPMG had done something "really precedent-setting" by "condition[ing] the payment of attorney’s fees on full cooperation with the investigation." KPMG took when federal prosecutors informed the firm of employees who were failing to cooperate in the government's investigation. In Bennett’s estimation, the steps taken by KPMG evidenced "a level of cooperation that is rarely done."

KPMG’s efforts to comply with federal prosecutors at all costs finally resulted in a successful outcome for the firm when on August 29, 2005, they entered into a “deferred prosecution agreement” with the government. As part of the “agreement to defer prosecution,” KPMG consented to a multitude of government conditions. First, KPMG had to admit to extensive criminal activity, which included their role in the “largest criminal tax case ever filed.” Specifically, KPMG admitted to engaging in a fraud that produced approximately $11 billion in artificial tax losses and cost the U.S. government roughly $2.5 billion in “evaded taxes.”

KPMG also agreed to pay the government a whopping total of $456 million in “fines, restitution, and penalties” as part of the deal. This included a payment of $100 million in “civil fines” for not registering the tax shelters with the government. A sum of $128 million in “criminal fines” which accounted for the “disgorgement of fees” KPMG collected on the tax shelters. Also part of the total penalty was $228 million in “criminal restitution” for lost taxes caused by KPMG’s obstinacy in submitting relative files and records to the IRS, which allowed the statute of limitations to expire.

The deferred prosecution agreement also required “permanent restrictions on KPMG’s tax practice.” These restrictions called for the complete elimination of two practice areas, the most fitting of which was the removal of the KPMG group that exclusively provided services to affluent individuals. Additionally, the agreement banned KPMG from selling any “pre-packaged tax products” and limited the firm’s ability to accept “fees not based on hourly rates.” The terms of the deal also called for KPMG to execute and sustain an “effective compliance and ethics program” and to employ an “independent, government-appointed monitor,” who will supervise the

177. Id. at 348–49.
178. Id. at 349.
179. Id.
180. Id.
183. Id.
184. Id.
185. Id.
186. Id.
188. Id.
189. Id.
190. Id.
191. Id.
192. The monitor appointed by the government was former Chairman of the Securities and Exchange
company's adherence to the conditions of the deferred prosecution agreement for a three-year time span.\footnote{193}

The condition levied by the government most pertinent to the KPMG employees involved in the current litigation though,\footnote{194} is what U.S. Attorney General Alberto R. Gonzalez termed in a Department of Justice press release as KPMG's "guarantee of cooperation."\footnote{195} In fact, KPMG was required in the agreement with the government to "acknowledge and understand" that the firm's cooperation in the ongoing criminal inquiry was a critical reason prosecutors even decided to enter into the deal.\footnote{196} KPMG's specific responsibilities related to "cooperation" included disclosing to prosecutors any information pursuant to government demands, promptly submitting any "documents, records, information, and other evidence," not asserting any claim of attorney-client or work product privilege connected to a government request, and making accessible (to the best of their ability) any current or ex-employees for interviews or sworn testimony.\footnote{197}

KPMG further agreed that its duty to cooperate would continue after they fulfilled the conditions of the deferred prosecution agreement and the government dismissed the related criminal information.\footnote{198} Part of this prolonged duty to cooperate consists of KPMG assisting the government in any "investigation, criminal prosecution or civil proceeding" related to the fraudulent tax shelter activities of the company or any of its current or former employees.\footnote{199} As long as KPMG fully complies with all of the conditions set forth in the agreement though, the government will forgo prosecuting the company for its fraudulent actions associated with the tax shelters.\footnote{200} According to Judge Kaplan in \textit{Stein}, "in a nutshell, KPMG stands to avoid a criminal conviction if it lives up to its part of the bargain."\footnote{201}

If KPMG fails to adhere to the conditions in the agreement, however, they will be exposed to the threat of the government claiming the deal was violated and then "prosecut[ing] the criminal information to verdict."\footnote{202} Another viewpoint on the potential violation of the agreement is that if the government regards any KPMG actions as not being "cooperative," the result will most assuredly result in a criminal conviction,

\begin{footnotes}
\item[193] Id.
\item[194] \textit{Stein}, 435 F. Supp. 2d 330.
\item[195] Dept. Just., \textit{supra} n. 181.
\item[196] \textit{Stein}, 435 F. Supp. 2d at 349.
\item[197] Id. at 350.
\item[198] Id.
\item[199] Id.
\item[200] Dept. Just., \textit{supra} n. 181. Technically, as long as KPMG has satisfied the conditions set forth in the deferred prosecution agreement as of December 31, 2006 (the expiration of the deferral period) the government will dismiss the criminal information. In reality, however, the continuing cooperation duty imposed on the firm effectively prolongs KPMG's responsibility to assist the government in any factually related litigation associated with the tax shelters. This extended duty in theory makes it possible for KPMG to still be charged with criminal wrongdoing after the deferral period, should they not meet the government's cooperation standards associated with any connected investigation or litigation. \textit{Id.; Stein}, 435 F. Supp. 2d at 350.
\item[201] \textit{Stein}, 435 F. Supp. 2d at 349.
\item[202] Id. at 350.
\end{footnotes}
due to the admissions that the firm has made in order to secure the deferred prosecution agreement. 203 At approximately the same time KPMG and the government entered into the agreement to defer prosecution, federal prosecutors filed the first criminal indictments associated with Stein implicating individual KPMG employees in the alleged tax shelter fraud. 204 Adhering to the new company policy implemented to secure “cooperator” status with the government, KPMG responded to the indictments by promptly terminating the payment of legal fees and expenses to the accused individuals. 205

When considering the effects a breach of the deferred prosecution agreement would have on KPMG, 206 it is very easy to understand why it would have spelled certain annihilation of KPMG as an entity if they would have ignored their new termination of legal fees policy and continued to pay the legal expenses of the now ex-employee criminal defendants in Stein. 207 KPMG was essentially placed in the unenviable position of having to choose between the probable extinction of their business, or sacrificing their own partners and employees whom the government had already labeled as culpable. 208 KPMG’s decision on the matter, influenced by heavy consideration of the Thompson Memo and the U.S. attorney’s position on the question, is what brings us to the present litigation in Stein. 209

E. The Motion to Dismiss and the Court’s “Ultimate Factual [and Legal] Conclusions” 210

On January 19, 2006, the former KPMG employees, now defendants in Stein, filed a motion to dismiss the indictment or for alternate relief 211 “on the ground that the government had interfered improperly with the advancement of attorney’s fees by KPMG in violation of their constitutional and other rights.” 212 In response to the defendant’s motion, the government took an aggressive stance on the issue, claiming that KPMG had analyzed their legal obligations to advance fees and “decided of its own volition” that it would condition payment of such fees on certain specified terms. 213

203. Id.
204. Id.; Lawrence J. Zweifach & Zachary S. Taylor, United States v. Stein and the Advancement of Attorney’s Fees: The Thompson Memorandum Under a Microscope, 1557 PLI/Corp 903, 909 (Sept. 2006); see also Dept. Just., supra n. 5 (detailing the charges against the defendants as “conspiracy to defraud the IRS, tax evasion and obstruction of the Internal Revenue Laws arising out of illegal tax shelters that Big 4-accounting firm KPMG and others designed, marketed and implemented”).
206. Id.
207. Id.
208. As mentioned in the opening paragraph of this casenote, Judge Kaplan described the situation as “KPMG refused[ing] to pay because the government held the proverbial gun to its head.” Id. at 336.
209. Id. at 330.
211. The KPMG defendants filed their motion for dismissal under Federal Rule of Civil Procedure 12(b). In addition to praying for the dismissal of their indictments, the defendants also sought alternate relief in the form of “directing the government to pay the defendants’ attorney’s fees from the settlement with KPMG” and/or “an injunction preventing the government from using the Thompson Memorandum to affect corporations’ policies regarding the advancement of fees.” Zweifach & Taylor, supra n. 204, at 909.
Prosecutors further claimed that the defendants could not point to any specific proof that would substantiate their claim that the government had “coerced” or “bullied” KPMG into adopting the revised policy on payment of legal fees.214

In a hearing addressing the motion on March 30, 2006, prosecutors employed for the first time the posture that it had “no objection whatsoever to KPMG exercising its free and independent business judgment as to whether to advance defense costs.”215 The government assured the court that if KPMG were to decide to advance fees to the defendants, the decision would not affect in any way KPMG’s status under the deferred prosecution agreement.216 Despite these assurances from prosecutors, the court “expressed concern” as to whether the Thompson Memo had indeed influenced KPMG’s decision to alter their legal fee payment policy.217 Consistent with this concern, the court subsequently instructed the defendants to submit in writing the exact issues in question that would support an evidentiary hearing on the matter.218

Federal prosecutors strongly opposed an evidentiary hearing, however, and responded by filing a brief with the court to combat the defendant’s submission supporting a hearing.219 The government’s argument against a hearing primarily relied on the assertion that “the United States Attorney’s Office did not instruct KPMG whether KPMG should pay legal fees, whether KPMG should cap the payment of legal fees, or whether KPMG should condition the payment of legal fees.”220 Apparently unconvinced by the government’s conclusory brief, the court decided that an evidentiary hearing was appropriate under the circumstances, and from May 8–10, 2006, conducted the hearing.221 The court narrowed the scope of the proceeding to the sole issue of “whether the government, through the Thompson [Memo] or otherwise, affected KPMG’s determination(s) with respect to the advancement of legal fees and other defense costs to present or former partners and employees” involved in the “investigation and prosecution” of the current litigation.222

After considering testimony from prosecutors and KPMG attorneys223 along with arguments from all involved parties pertaining to the legal fee issue, the court arrived at four “ultimate factual conclusions” stemming from the evidentiary hearing.224 The first three factual findings Judge Kaplan articulated225 provided the building blocks for the

214. Id.
215. Id. at 351.
216. Id.
217. Stein, 435 F. Supp. 2d at 351.
218. Id.
219. Id.
220. Id. at 352.
221. Id.
223. Browning, supra n. 222.
225. The first conclusion of fact was that “the Thompson [Memo] caused KPMG to consider departing from its long-standing policy of paying legal fees and expenses of its personnel in all cases and investigations even before it first met with the [federal prosecutors].” The second finding of fact was that “the [federal prosecutors] did not give KPMG the comfort it sought” but rather “consistent with DOJ policy, reinforced the
fourth conclusion, which served as the court's ultimate determination concerning the legal fee debacle. In a clearly written summation of the issue, Kaplan held that:

KPMG's decision to cut off all payments of legal fees and expenses to anyone who was indicted and to limit and to condition such payments prior to indictment upon cooperation with the government was the direct consequence of the pressure applied by the Thompson [Memo] and the [federal prosecutors]. Absent the Thompson [Memo] and the actions of the [federal prosecutors], 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.

By squarely placing the blame on the government for KPMG's abandonment of its longstanding indemnification and advancement practices, Judge Kaplan developed the factual ammunition needed for an extremely detailed legal analysis of how the government actions violated the constitutional rights of the individual KPMG defendants.

Because this casenote's primary focus is on the remedies the court provides the violated defendants, only a brief assessment of Judge Kaplan's legal findings will be tendered in light of his exceptionally thorough legal discussion that spans approximately twenty pages in the Stein opinion. Kaplan began his legal analysis by establishing that "[t]he Supreme Court long has protected a defendant's right to fairness in the criminal process." He subsequently found that the right to fairness in criminal proceedings was a "fundamental liberty interest" deserving substantive protection under the Due Process Clause of the Fifth Amendment of the U.S. Constitution. According to Supreme Court jurisprudence then, any fundamental right so vital to personal liberty "cannot be infringed by the government unless the infringement is narrowly tailored to serve a compelling state interest." This constitutionally interpreted standard is widely referred to as the "strict scrutiny test."

Kaplan found that the specific infringement by the government requiring strict scrutiny application was the language in the Thompson Memo concerning the payment of legal fees along with the prosecutors' behavior during the investigation, which had pressured KPMG to terminate payment of the defendants' legal expenses. This interference affected the ability of the former employees to "obtain resources they otherwise would have had" which in turn prevented them from advancing the defense of their choice. The court found this to be a major obstruction given the complexity and

threat inherent in the Thompson [Memo]." The third factual conclusion was that "the government conducted itself in a manner that evidenced a desire to minimize the involvement of defense attorneys." Id. at 352–53.

226. Id. at 353.
227. Id.
228. Id. at 340.
230. The legal "discussion" section of the Stein opinion begins on page 353 of the opinion and ends on page 373.
231. Id. at 357.
232. Id. at 360; U.S. Const. amend. V.
234. Id. at 362.
235. Id.
236. Id.
cost associated with the defendants mounting an adequate defense in the “largest tax fraud case in United States history.”

Judge Kaplan then explained that the government actions were not narrowly tailored because they did not exclusively apply to situations where a company was advancing fees in an effort to “[circle] the wagons” and obstruct a government inquiry. Instead, the government actions also applied to circumstances where a company was fully cooperating with a federal investigation but was also advancing fees to implicated employees under perfectly valid state indemnification statutes. Statutes that states had purposely enacted as a policy decision to protect the “legitimate public interests” inherent in indemnification and advancement practices. For these reasons, Kaplan expressly held that both the “legal fee advancement provision” of the Thompson Memo and the prosecutors’ conduct in the case violated the Due Process Clause.

In the second part of the court’s legal discussion, Kaplan found that the “Thompson [Memo] and its implementation by the government” violated the defendants’ right to counsel and right to “mount the defense” of their choosing as protected by the Sixth Amendment. The government knowingly executed its actions with the goal of restricting the defendants’ access to legally available resources that would support their “constitutional rights to defend themselves.” Unless the government provided a sufficient justification for their conduct, the actions stood as blatant violations of the Sixth Amendment. The court held that any law enforcement interest the government claimed in interfering with the defendants’ rights was clearly outweighed by the need to ensure the “proper functioning of the adversary process” chosen by the constitution to decide the outcome of criminal cases. Consequently, Kaplan declared the government actions unjustified and reiterated the importance of the defendants’ Sixth Amendment right to “defend themselves” with lawfully accessible funds in an enormously intricate and costly criminal trial.

IV. ANALYSIS

A. First, a Primer on Indemnification and Advancement of Legal Fees

Indemnification is simply a method for companies to “reimburse its officers, directors, and employees for personal losses they suffer as a result of the proper exercise
of their official responsibilities." It is a widely accepted legal concept as evidenced by the fact that all fifty states plus the District of Columbia have enacted statutes providing for its application. Support for indemnification is generally based on two main policy assertions. First, it persuades competent people to pursue corporate service positions since they know their personal assets will not be at risk for actions they take on the company’s behalf. Second, indemnification promotes aggressive risk-taking for the company’s benefit due to the employees’ knowledge that he will not be held personally liable if his decisions do not result in a successful outcome.

Indemnification statutes come in two forms, mandatory and permissive. Employers are typically responsible for mandatory indemnification when an employee covered by an indemnification statute “succeeds on the merits of the case and defeats liability.” Permissive indemnification refers to the situation where an employee is not “successful on the merits or otherwise” and instead, the company has discretion whether or not to indemnify the employee for their legal expenses. In these circumstances, the company’s charter, bylaws, partnership agreement, or individual contract is consulted to determine if the employee has a right to indemnification. If the right to indemnification is not clearly expressed in any of the previous sources, the company may still provide for indemnification on a “case-by-case basis.”

Advancement of legal fees is an “especially important corollary to indemnification” as a technique in persuading talented people to accept corporate positions. Advancement affords employees “immediate interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved with investigations and legal proceedings.” The majority of state statutes on advancement are permissive; however, a company can elect to render the advancement of legal fees mandatory by specifying as such in their “certificate of incorporation or bylaws, or by contract.” Most large companies today, in an effort to attract the best talent, routinely provide for mandatory advancement with hardly any conditions or stipulations on the entitlement.

At the same time, most state statutes directly limit a company’s ability to advance

248. Id.
249. Id.
250. Id.
251. Id.
252. Olson et al., supra n. 6, at 187.
253. Id.
254. Id.
255. Id. A company’s ability to provide for indemnification through its bylaws or other company documents in situations not dictated by state statute can also be viewed as creating a “mandatory” right of indemnification for an employee. Considering that it is at the company’s discretion to enact such provisions though, it is also logical to label such practices as “permissive.” Id.
256. Villa, supra n. 247, at § 5:8[E].
258. Id.
259. Olson et al., supra n. 6, at 188.
legal fees to certain specified circumstances. Once an employee has satisfied any applicable statutory requirements and is entitled to advancement under a company’s provisions, it is “extremely difficult for [the company] to avoid completely fulfilling its obligation to advance fees” under the majority of state statutes. Due to strong public policy favoring advancement, courts generally will not allow a company with ambiguous advancement terms to “impose litigation-driven, after-the-fact conditions on what is otherwise an unconditional right to advancement.”

B. Corporation Law + Partnership Law = A Remedy for the Defendants

Under Supreme Court jurisprudence, remedies for violations of constitutional rights “should be tailored to the injury suffered” and “should not unnecessarily infringe on competing interests” such as the “interest in the administration of criminal justice.” The court’s theory has been to “identify and then neutralize the taint by tailoring relief appropriate in the circumstances to assure the defendant the effective assistance of counsel and a fair trial.” Applying this judicious approach, Judge Kaplan fashioned two primary remedies in Stein designed to restore the defendants “to the position they would have occupied had the government not interfered improperly with their prospects for advancement of defense costs.” This “position” could be satisfied if “defense costs already incurred and yet to be incurred [by the defendants] are paid.”

One remedy proffered by Kaplan was for KPMG, on its own initiative or at federal prosecutors’ insistence, to advance to defendants the legal costs associated with the litigation. Because the government was held responsible for the constitutional violations in Stein, Kaplan believed prosecutors should “seek to remedy the problem it has created.” For example, prosecutors could exercise their power over KPMG via the cooperation clauses in the deferred prosecution agreement to force KPMG to advance the legal fees to the defendants. KPMG, likewise, could take the initiative to remedy the situation by realizing that any efforts by the firm to stymie the advancement of fees to former employees could have a drastic chilling effect on their future “interest in recruiting and retaining top flight personnel.”

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261. Olson et al., supra n. 6, at 188.
262. Villa, supra n. 247, at § 5:8[E] (describing procedures set forth in Section 145(e) of the Delaware General Corporation Law). “An undertaking is not required for employees and agents, or former directors and officers.” Olson et al., supra n. 6, at 188.
263. Ladig, supra n. 260.
264. Id.
266. Id.
267. Id. at 380.
268. Id. at 374.
269. Id.
271. Id. at 380.
272. Id.
remedying the situation were, through the benefit of hindsight, it is now possible to declare these approaches impotent given the current reality of the situation. 273 In a show of defiance, both KPMG and the government have since appealed the Stein ruling and KPMG has been anything but responsive to further attempts by the defendants to obtain legal fees. 274

Judge Kaplan also articulated an alternate remedy for the defendants in Stein known simply as a “summary advancement proceeding,” which is the target of this casenote’s primary analysis. 275 The significance of this particular remedy is attributed to Kaplan’s resourceful application of both Delaware corporate law and partnership law. 276 KPMG is a limited liability partnership organized under the laws of Delaware and subject to the Delaware Revised Uniform Partnership Act (DRUPA). 277 The indemnification provision in the DRUPA is permissive and provides that “a partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever.” 278 Under the statute, partnerships can condition indemnification on “such standards and restrictions” as it deems necessary to “set forth in its partnership agreement.” 279 The advancement of legal fees is not expressly provided for in the DRUPA, however, Delaware courts have granted partnerships the “authority to advance defense costs prior to final judgment” given the broad construction of the indemnification statute. 280

While the authority to advance legal fees has been extended to Delaware partnerships through case law, the right to a summary advancement proceeding pursuant to Delaware corporate law has never been expressly extended to a limited liability partnership. 281 This represents the ingenuity inherent in Judge Kaplan’s remedy formulated for the defendants in Stein. 282 Kaplan points to Delaware corporate law to afford the defendants the right to a summary advancement proceeding even though KPMG is a limited liability partnership governed by the DRUPA and not the Delaware General Corporation Law (DGCL). 283 Section 145 of the DGCL vests the Delaware Court of Chancery with “exclusive jurisdiction to hear and determine all actions for

273. See Lynnley Browning, KPMG Strikes Back at Former Employees in Tax Shelter Case, N.Y. Times C4 (Sept. 19, 2006).
274. Id. In response to a civil action filed by the defendants to recover legal expenses, KPMG counterclaimed by alleging breaches of fiduciary duty, embezzlement, civil theft, and conversion against several of the former employees. See Answer, Affirmative Defs., and Counterclaims of Def. KPMG LLP to Civ. Compl. at ¶¶ 1-44, Stein et al. v. KPMG LLP, 2006 WL 2922084 (S.D.N.Y. Sept. 18, 2006).
276. Id.
277. Id. at 355 n. 117; Del. Code Ann. tit. 6, § 106.
279. Id.
281. According to research conducted on Westlaw as of November 27, 2006, no case involving a Delaware partnership has been expressly associated with a summary advancement proceeding granted pursuant to Delaware corporate law. See Del. Code Ann. tit. 8, § 145(k).
advancement of expenses or indemnification brought under this section." The section further states that the court "may summarily determine a corporation’s obligation to advance expenses (including attorney’s fees)."

The general benefit of a summary advancement proceeding is its expediency and constricted scope which allows parties who are financially dependent on their employer for the payment of legal fees a quick resolution of the advancement dispute. The purpose of a summary advancement proceeding under Section 145(k) of the DGCL is restricted to "determining the issue of entitlement according to the corporation’s advancement provisions and not to issues regarding the movant’s alleged conduct in the underlying litigation." The proceeding is not designed to determine a movant’s ultimate right to indemnification, since a party is not entitled to indemnification until they have been “successful on the merits or otherwise” in the defense of their respective litigation. Instead, the only goal of the proceeding is to determine whether an individual has a right to the advancement of legal fees, which does not require a successful outcome on the merits of the case. Given the wealth of benefits a summary advancement proceeding offers, it is clear why Judge Kaplan constructed such a remedy for the defendants in Stein who are involved in such a massively complex and expensive criminal trial. The prompt resolution of the legal fee dispute between KPMG and its former employees should be justly served under a summary advancement proceeding.

An issue not as clear, however, is why Delaware partnership law does not share similar provisions governing the indemnification and advancement of legal fees as Delaware corporate law. While this is by no means an accurate reflection of the substance of the respective sections, it is alarming that Section 145 of the DGCL consists of eleven subsections while Section 15-110 of the DRUPA has but one section consisting of one sentence. Why is it necessary to have indemnification and advancement provisions so overtly contrasting simply because they address a different form of business entity? If indemnification and advancement of legal fees truly are “principles of American law” as Judge Kaplan so passionately contends, then why do states such as Delaware provide for these “principles” in separate statutes according to business form? Due to the strong public policy support in favor of the indemnification and advancement of legal fees, states should provide one piece of legislation pertaining to the concepts and apply it to all business entities regardless of form. This would ensure the consistent and fair application of indemnification and advancement principles in all future conflicts.

285. Id.
290. Id.
293. Id.
295. See Ladig, supra n. 260.
such as the one in *Stein*. 296

V. CONCLUSION

Judge Kaplan’s opinion in *Stein* stands poised to have a tremendous impact on the future landscape of corporate criminal prosecution, and on the continued support of the “principles” of indemnification and advancement of legal fees. 297 While the opinion’s persuasive authority is presently restricted to the Southern District of New York, the court is an “important venue for corporate and white-collar prosecutions, and its pronouncements always have been highly influential.” 298 The ruling should promote additional challenges to the Thompson Memo and its “strong-arm application by frontline prosecutors.” 299 *Stein*’s attack on the constitutionality of the Thompson Memo has already influenced further assaults on the government guidelines. For example, on September 12, 2006, the Senate Judiciary Committee conducted a hearing targeting the controversial guidelines and its effects on both corporations and employees under investigation. 300 In response to federal prosecution tactics, both the chairman of the committee and its ranking minority member claimed that the “practices were coercive and called on [the Deputy Attorney General] to have them modified.” 301 Although it remains to be seen, the *Stein* opinion could prove to be the “push” that gets the post-Enron “regulatory pendulum [moving] in the opposite direction.” 302 As U.S. Treasury Secretary Henry M. Paulson recently stated, “Often the pendulum swings too far and we need to go through a period of readjustment.” 303 For the benefit of corporate America and its employees, maybe that time has arrived.

*Trent O. Bridges*

296. It would also prevent the need for judges to essentially create new law from the bench simply because one particular business entity’s indemnification and advancement statute doesn’t expressly provide for a given procedure or right. *See e.g.* *Stein*, 435 F. Supp. 2d 330.

297. *Id.*


299. *Id.*


301. *Id.* Senator Arlen Specter, a Pennsylvanian Republican, was the chairman, and Senator Patrick Leahy, a Vermont Democrat, was the committee’s ranking minority member. *Id.*


303. *Id.*

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