Legal Backgrounder

Washington Legal Foundation
Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 22 No. 19 June 8, 2007

WHITE COLLAR CRIME POLICY ON LEGAL FEE PAYMENT IMPLICATES CIVIL LIBERTIES

by

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A headline in the October 19, 2001 edition of *The Wall Street Journal* read "Enron CFO's Partnership Had Millions in Profit."[1] That day, Enron's stock fell to $29/share down from a 52-week high of over $80/share. By December 2001, Enron had collapsed and filed for bankruptcy protection. The era of corporate scandals in the United States then began in earnest.

The plots, props, and main characters from the scandals are by now familiar: Ebbers and Rigas, raptors and shower curtains, insider trading and improper accounting, public outrage and Sarbanes-Oxley.

Some actors in this drama are less familiar: Holder and Thompson, McCallum and Kaplan, Specter and McNulty. Those are the names of the protagonists or antagonists, depending on one's perspective, in one aspect of the story of the prosecutorial response to the scandals that roiled corporate America.

This LEGAL BACKGROUNDER addresses the United States Department of Justice's "Principles of Federal Prosecution of Business Organizations," and, in particular, the evolution of how federal prosecutors respond to a decision by a corporation, suspected of wrongdoing, to pay the legal fees of corporate directors, officers, employees, or agents who have also drawn prosecutorial attention.

The story begins, pre-Enron, in the later stages of the Clinton administration, at the desk of then-Deputy Attorney General of the United States, Eric H. Holder, Jr.

The "Holder Memo". On June 16, 1999, Eric Holder signed and released a memorandum, directed to all U.S. Attorneys, that provided "guidance as to what factors should generally inform a prosecutor in making the decision whether to charge a corporation" with criminal wrongdoing ("Holder Memo").[2] The guidance contained in the Holder Memo was not binding on federal prosecutors. Holder wrote that "prosecutors are not required to reference these factors in a particular case." Instead, the factors were only "guidelines" and Holder expected and solicited comments and proposed changes from prosecutors to the guidelines.

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[1]Rebecca Smith and John R. Emshwiller, *Enron CFO's Partnership Had Millions in Profit*, WALL ST. J., Oct. 19, 2001, at C1.

[2]The Holder Memo is available at www.usdoj.gov/criminal/fraud/policy/chargingcorps.html.

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The Holder Memo listed eight factors that prosecutors "should consider" in deciding how to proceed against a corporate target. The fourth factor suggested that prosecutors take into account a corporation's "cooperation" with prosecutors. In a more detailed discussion of the cooperation factor, the Holder Memo asserted that prosecutors could look askance at a decision by a corporate target to advance attorneys' fees to the corporation's "culpable" employees and agents. Specifically, the Holder Memo stated that "a corporation's promise of support to culpable employees and agents . . . through the advancing of attorneys fees . . . may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation."[3] In those pre-Enron days, the Holder Memo did not receive much scrutiny or elicit any measurable controversy.

The "Thompson Memo". Larry D. Thompson became the Deputy Attorney General in 2001. On January 20, 2003, with the corporate scandals still at or near a full boil, Thompson issued a memo entitled "Principles of Federal Prosecution of Business Organizations" ("Thompson Memo"). The Thompson Memo closely tracked the provisions of the Holder Memo. The Thompson Memo adopted wholesale the Holder Memo's analysis of a corporate decision to advance attorneys' fees to corporate agents.[4] The Thompson Memo, however, departed from the Holder Memo by making it mandatory for prosecutors to take the listed factors into account in deciding how to proceed against a corporate target.[5]

The Death of Arthur Andersen. Arthur Andersen, LLP served as Enron's auditor. After Enron's demise, Arthur Andersen, like Mary Surratt, was sent hastily to the gallows during a period of intense public outrage over a notorious crime. On March 14, 2002, federal prosecutors indicted Arthur Andersen for obstruction of justice related to the government's Enron investigation. The indictment itself effectively served as a death sentence for Arthur Andersen because it led to a mass exodus of clients, partners, and employees. Critics complained that the indictment, and eventual conviction, wrongly punished thousands of innocent Arthur Andersen partners and employees for the transgressions of a limited number of individuals.[6] The criticism crested when, in 2005, long after the firm ceased active operations, the United States Supreme Court overturned the conviction of Arthur Andersen.[7]

Judge Kaplan's Stunning Rejection of the Thompson Memo. In June 2006, with the flood of corporate scandals and the wave of public outrage receding, United States District Judge Lewis A. Kaplan, from the Southern District of New York, issued a remarkable decision declaring the Thompson Memo unconstitutional due to its provisions concerning a corporation's advancement of attorneys' fees to its agents.[8]

The *Stein* prosecution had its genesis in the government's investigation into KPMG's promotion of dubious tax shelters. During its investigation of KPMG, the U.S. Attorney's Office for the Southern District of New York ("USAO") held discussions with KPMG's lawyers about the possibility of a corporate indictment. In those discussions, USAO invoked the Thompson Memo, and put pressure on KPMG not to advance legal fees to the individual KPMG employees who were also implicated in the investigation. KPMG, desperate to avoid Arthur Andersen's fate, largely succumbed to that pressure and succeeded in avoiding a corporate indictment. The USAO and KPMG entered into a deferred prosecution agreement that called for KPMG to pay a $456 million fine. It was also contingent on KPMG's continued cooperation with the USAO. At about the same time, the prosecutors brought indictments against individual KPMG employees (collectively "Stein"). KPMG promptly cut off payments of attorneys' fees to those employees.

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[3]The Holder Memo acknowledged in a footnote that, in some instances, corporations may be required by state law to advance legal fees to their agents. The Holder Memo conceded that "a corporation's compliance with governing law should not be considered a failure to cooperate."

[4]See *United States v. Stein*, 435 F. Supp. 2d 330, 338 (S.D.N.Y. 2006).

[5]The Thompson Memo stated that, in "all cases involving corporate wrongdoing, prosecutors should consider the factors discussed herein." See also *Stein*, 435 F. Supp. 2d at 338 ("Unlike its predecessor, . . . the Thompson Memorandum is binding on all federal prosecutors.").

[6]*See*, *e.g.*, *Arthur Andersen's "Victory"*, WALL ST. J., June 1, 2005 ("A retrial won't help the firm's 28,000 former employees").

[7]*Arthur Andersen, LLP v. United States*, 544 U.S. 696 (2005).

[8]*See United States v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

Stein challenged the conduct of the USAO and the constitutionality of the Thompson Memo. After holding an evidentiary hearing, Judge Kaplan held that the Thompson Memo and the USAO's conduct concerning the advancement of attorneys' fees was unconstitutional under the Fifth Amendment's due process clause and the Sixth Amendment's assistance of counsel clause. Judge Kaplan was unsparing in his criticism of the Thompson Memo and the implementation of its provisions by the USAO. Judge Kaplan wrote that:

- "KPMG refused to pay because the government held the proverbial gun to its head."
- "The government . . . has let its zeal get in the way of its judgment. It has violated the Constitution it is sworn to defend."
- "The determination of guilt or innocence must be made fairly – not in a proceeding in which the government has obtained an unfair advantage long before the trial even has begun."

Judge Kaplan rejected the Thompson Memo because it gave the USAO the authority and ability to game the system by deliberately interfering with Stein's access to counsel. The prosecutors, according to Judge Kaplan, were pursuing convictions at the expense of fairness to the defendants, a bargain that the Constitution forbids. Consequently, Judge Kaplan postponed Stein's criminal trial pending a resolution of ancillary civil proceedings over Stein's fees and a decision from the Second Circuit on appeal from Judge Kaplan's rulings.[9]

The "McNulty Memo". On December 12, 2006, Paul J. McNulty, the current Deputy Attorney General,[10] issued a new memorandum ("McNulty Memo") to supersede and replace the Thompson Memo.[11] The McNulty Memo was the Department of Justice's response to Judge Kaplan's *Stein* decision and congressional criticism of the Thompson Memo.[12]

The McNulty Memo emphasizes cooperation between "responsible corporate leaders" and the Department of Justice, and the need for prosecutors to maintain "professionalism and civility" in order to engender public and corporate confidence in the Department and its tactics. In furtherance of those goals, the McNulty Memo departs from the provisions of the Thompson Memo in important ways. With regard to the cooperation factor, the McNulty Memo continues to instruct prosecutors to take into account "whether the corporation appears to be protecting its culpable employees and agents." However, in making that determination, prosecutors, under the McNulty Memo, "generally *should not take into account* whether a corporation is advancing attorneys' fees to employees or agents under investigation or indictment." (Emphasis added)[13]

The McNulty Memo's treatment of a corporation's advancement of attorneys' fees leaves a few questions unanswered. First, while the McNulty Memo is clear that prosecutors cannot hold the advancement of fees

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[9]On May 23, 2007, the Second Circuit held that Judge Kaplan erred in exercising ancillary jurisdiction over Stein's civil suit to force KPMG to cover Stein's fees. The merits of Judge Kaplan's constitutional repudiation of the Thompson Memo were not before the Second Circuit and the appellate court did not address those issues directly, but the panel gave the distinct impression that it generally was not enamored with Judge Kaplan's handling of the case. *See*, *e.g.*, *Stein v. KPMG, LLP*, No. 06-4358-cv at 19 (2d Cir. May 23, 2007) ("while the ancillary proceeding is a major undertaking, its contribution to the efficient conclusion of the criminal proceeding is entirely speculative").

[10]McNulty succeeded Robert McCallum, Jr. McCallum, in 2005, issued the "McCallum Memo," which required U.S. Attorneys to put in place formal proceedings for line prosecutors to follow when seeking a waiver of the attorney-client privilege from corporate targets under the Thompson Memo. The McCallum Memo is available online at lawprofessors.typepad.com/whitecollarcrime_blog/files/AttorneyClientWaiverMemo.pdf. McNulty recently announced his resignation pending the appointment of a successor.

[11]The McNulty Memo is available at www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf.

[12]The Thompson Memo drew the particular ire of Senator Arlen Specter (R. Pa.) who, on December 7, 2006, introduced a bill entitled the "Attorney-Client Privilege Protection Act."

[13]The McNulty Memo goes on to say that in "extremely rare cases," a prosecutor can take a corporation's advancement of fees into account where there is evidence that the corporation's intent is to "impede a criminal investigation." However, even in those extraordinary cases, a prosecutor must obtain personal approval from the Deputy Attorney General before the prosecutor can take an advancement of fees into account. Under the McNulty Memo, prosecutors remain free to ask "routine questions" about the "representation status of a corporation and its employees, including how and by whom attorneys' fees are paid."

against a corporate target, it is not clear whether prosecutors can still look favorably on a corporation's refusal to advance fees to its employees. One does not need to strain to conclude that such favorable treatment could remain permissible. While prosecutors are now restricted from pressuring corporations to waive the attorney-client privilege, the McNulty Memo expressly permits prosecutors to give bonus points to corporations that "voluntarily" do so. If prosecutors similarly retain the discretion to grant preferential treatment to corporations that voluntarily refuse to advance legal fees to their employees, corporate targets anxious to curry favor with prosecutors would still have significant incentive to do so, and the constitutional concerns that so exercised Judge Kaplan would persist.

Second, after its apparently blanket statement that prosecutors should not take the advancement of fees into account, the McNulty Memo immediately goes on to describe how corporations may be under statutory or contractual obligations to advance fees to their agents or employees. That juxtapositioning could give rise to an argument that the prohibition on punishing a corporation for advancing legal fees applies only when the advancement is obligatory. The McNulty Memo does not mention specifically how prosecutors should treat a corporation that advances fees even when under no obligation to do so. Given *Stein* and the McNulty Memo's seemingly sweeping blanket prohibition, such corporate volunteers should be protected, but some doubt remains.

Finally, the issuance of the McNulty Memo may or may not forestall legislative intervention. Senator Specter has reintroduced the Attorney-Client Privilege Protection Act. That proposed statute would codify a prohibition on any prosecutorial consideration of the advancement of legal fees in evaluating a corporation's level of cooperation with the government. Legislation on this subject would bring a measure of certainty and predictability that has been lacking.

Conclusion. The McNulty Memo applies a necessary push on the pendulum to return it back to equilibrium in the prosecution of corporate malfeasance. Aggressive prosecution, of course, is appropriate and desirable to combat wrongdoing of any stripe. However, there is a line between aggressiveness and over-zealousness. Prosecutorial actions that seek deliberately to deprive defendants of access to the best lawyers available to them cross that line. As Judge Kaplan noted:

> No system worth preserving should have to fear that if an accused is permitted to consult with a lawyer, he will become aware of, and exercise [his or her] rights. If the exercise of constitutional rights will thwart the effectiveness of a system of law enforcement, there is something very wrong with that system.[14]

It is not fair to hit home runs when the other side cannot pitch inside.

Although it took the *Stein* decision and the threat of legislative intervention to provide the necessary impetus, the Department of Justice has responded to some of the prosecutorial excesses that resulted from the U.S. corporate scandals. The McNulty Memo, while not without its flaws, puts in place a necessary check on prosecutorial power so that fairness and justice are not sacrificed for convictions.

[14] *Stein*, 435 F. Supp. 2d at 366, quoting *Escobedo v. Illinois*, 378 U.S. 478, 490 (1964).

  ISBN 1056 3059