

UNITED STATES V. STEIN - WAS THE GOVERNMENT'S CONDUCT OUTRAGEOUS?

~ Joseph W. Martini and James I. Glasser*

U.S. District Judge Lewis A. Kaplan has issued a series of remarkable opinions in *United States v. Stein* – a case reported to involve the largest tax fraud prosecution ever brought by the United States Government.¹ Judge Kaplan's latest decision, the third in the series ("*Stein III*"), orders the dismissal of charges against thirteen defendants based on a finding of outrageous government conduct. This article discusses the relevant facts and the extraordinary remedy ordered in this prosecution.

Criminal Conduct Alleged Against KPMG and Its Partners

The indictment in *United States v. Stein* alleges that KPMG designed, marketed and established fraudulent tax shelters that served to deprive the government of over \$2 billion in tax revenues. The government's investigation, which focused on wrongdoing by KPMG and certain of its partners, blossomed as additional evidence was uncovered. Seeking to avoid indictment, and the fate of Arthur Andersen,² KPMG entered into significant negotiations with government prosecutors. Those negotiations ultimately resulted in a deferred prosecution agreement for the corporation. It is the conduct of the government lawyers during these negotiations, and the Department of Justice's then-binding Thompson Memorandum, that are at the heart of Judge Kaplan's most recent decision.

The Holder-Thompson Memoranda

Since the summer of 1999, the Department of Justice has issued policy directives and guidelines to United States Attorneys governing the prosecution of corporations.

These memoranda have provided a blueprint for virtually all discussions between government lawyers and corporate counsel regarding alleged criminal conduct by a corporate entity.

In June 1999, then-Deputy Attorney General Eric Holder issued a document entitled *Federal Prosecution of Corporations* (the "Holder Memorandum") to provide "guidance as to what factors should generally inform a prosecutor in making the decision whether to charge a corporation in a given case." Among the factors identified was a corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents . . .³

On January 20, 2003, then-Deputy Attorney General Larry Thompson issued a superseding document entitled *Principles of Federal Prosecution of Business Organizations* (the "Thompson Memorandum").⁴ The Thompson Memorandum carried forward and built on the Holder Memorandum. Significantly, when the Thompson Memorandum issued, an accompanying memorandum to all United States Attorneys advised: "the main focus of the revisions is increased emphasis on and scrutiny of the authenticity of a corporation's cooperation. Too often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation."⁵

The Thompson Memorandum instructed federal prosecutors to consider certain fac-

tors in determining whether to charge a corporation, including:

"... whether the corporation appears to be protecting its culpable employees and agents. Thus, while cases will differ depending on the circumstances, 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. . . ."⁶

The Thompson Memorandum thus directed prosecutors to consider the payment of legal fees by business entities, except such advances as are required by law, as a possible indication of an attempt to protect culpable employees and as a factor weighing in favor of indictment. It is hardly surprising, therefore, that during meetings between experienced prosecutors and seasoned defense counsel for KPMG, the Thompson Memorandum provided a framework for settlement discussions.

Prosecutors Inquire Whether KPMG Intends to Pay Attorneys' Fees

While the deferred prosecution agreement was under negotiation, KPMG and prosecutors had a pointed discussion concerning whether KPMG would pay attorneys' fees for partners and employees who were subjects or targets of the government's investigation. During those discussions, prosecutors made specific reference to the Thompson Memorandum. The record, as set forth in Judge Kaplan's decisions, shows that while discussing the

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propriety of charging KPMG, prosecutors asked whether KPMG was going to pay the fees of current and former employees and whether there was a statutory or contractual obligation to do so.⁸ Prosecutors repeated to KPMG's lawyers the well-worn maxim that "misconduct" should not be "rewarded" and indicated that if the accounting firm had discretion concerning payment of attorney's fees, its decision to pay such fees would be scrutinized under a "microscope."⁹

Shortly after this meeting with prosecutors, KPMG advised the government that it would pay employees' legal fees and expenses up to a maximum of \$400,000, on the condition that the employee "cooperate fully with the company and the government." Importantly, KPMG went further and made clear that "payment of . . . legal fees and expenses will cease immediately if . . . [the recipient] is charged by the government with criminal wrongdoing."¹⁰

KPMG also capitulated to a government demand that it amend its previous advisory to its personnel by suggesting that employees were free to speak with government investigators without counsel. The *Stein* court later noted that this demand by the government was designed "to increase the chances that KPMG employees would agree to interviews without consulting or being represented by counsel."¹¹ Moreover, in a demonstration of its level of cooperation, KPMG's counsel asked the government for notification of any KPMG employee who refused to cooperate with the government. When KPMG was later so notified, the accounting firm cut off the payment of legal fees and terminated employees who refused to cooperate with the investigation.¹²

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KPMG's Deferred Prosecution, the Indictment of the KPMG Defendants, and KPMG's Decision to Stop Paying Attorneys' Fees

KPMG was ultimately successful in persuading the government to agree to a deferred prosecution agreement. Pursuant to that agreement, the accounting firm acknowledged significant wrongdoing involving a complex tax fraud designed to deprive the United States of considerable tax revenues. The agreement required, among other things, permanent restrictions on KPMG's tax practice, the implementation of an effective compliance and ethics program monitored by a government-appointed monitor, and the payment of fines of nearly one half billion dollars. Notably, the deferred prosecution agreement also required KPMG's full and truthful cooperation in the pending criminal investigation of individual defendants.¹³

While KPMG avoided prosecution, nineteen individuals, including sixteen former KPMG partners and the former deputy chairman of the firm (the "KPMG Defendants"), were indicted. Following indictment, KPMG, true to its word to the government, cut off the payment of legal fees to the KPMG Defendants.

The Motion to Dismiss, and Stein I

The KPMG Defendants moved to dismiss the indictment on constitutional grounds, claiming that the government interfered improperly with the advancement and payment of attorneys' fees by KPMG in violation of their Fifth and Sixth Amendment rights. In response, the prosecutors claimed that they did not instruct KPMG about whether it should pay legal fees, cap the payment of legal fees, or condition the payment of legal fees on cooperation. Rather, the prosecutors asserted that KPMG formulated its ultimate policy regarding the payment of attorneys' fees "of its own volition."¹⁴

After an unusual evidentiary hearing involving testimony from government

prosecutors and the introduction of lawyers' notes taken during settlement discussions, Judge Kaplan took issue with the prosecutors' representations, finding that prosecutors were "economical with the truth."¹⁵ Judge Kaplan further found that:

- The Thompson Memorandum caused KPMG to consider departing from its long-standing policy of paying legal fees and expenses, and as a result KPMG sought assurances from the prosecutors that payment of fees in accordance with its past practice would not be held against it.
- Prosecutors did not give KPMG the comfort it sought. Instead, they reinforced the threat inherent in the Thompson Memorandum, that is, that payment of legal fees, absent a legal obligation to do so, would be held against KPMG.
- Prosecutors conducted themselves in a manner evidencing a desire to minimize the involvement of defense attorneys.
- KPMG's decision to cut off all payments of legal fees and expenses to anyone who was indicted and to limit and condition such payments prior to indictment upon cooperation with the government was the direct consequence of the pressure applied by the Thompson Memorandum and prosecutors. The court further found that but for the Thompson Memorandum and the conduct of the 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.¹⁶

Based on the foregoing, Judge Kaplan found both a Due Process violation and a Sixth Amendment violation. More particularly, the court found that the Thompson Memorandum, coupled with the pressure brought to bear on KPMG to cut off defendants' attorneys' fees, offended the fundamental fairness required in criminal prosecutions because it served to deprive defendants of the ability to adequately defend themselves in violation of the Due

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Process Clause. The court also found that the government's conduct actively or constructively denied the KPMG Defendants their right to counsel of choice at a critical stage of the trial, in violation of the Sixth Amendment. Given the complex nature of the evidence, the court presumed prejudice to the defendants.¹⁷

Judge Kaplan concluded, however, that the violation was curable if KPMG paid the employees' legal expenses. He directed the court clerk to open a civil docket number, asserted ancillary jurisdiction, and invited the KPMG Defendants to file civil claims against KPMG for their defense costs. The defendants subsequently filed state law contract claims seeking to compel KPMG to advance legal fees. KPMG appealed, arguing that the district court lacked subject matter jurisdiction over the defendants' claims. The Second Circuit treated the appeal as a petition for a writ of mandamus and granted the petition, ordering dismissal of the defendants' complaints against KPMG.¹⁸ The KPMG defendants thereafter renewed their motions to dismiss the indictment.

*Stein III*¹⁹

Responding to the renewed motions, prosecutors vigorously disputed many of the factual determinations made by the court in *Stein I*. In *Stein III*, Judge Kaplan not only reaffirmed his earlier conclusions, but also supplemented them with "new" evidence that KPMG cut off payment of legal fees as a consequence of government coercion.²⁰ Ultimately, Judge Kaplan found that the government's conduct "shocked the conscience," and that dismissal was the appropriate remedy as to thirteen of the sixteen KPMG defendants.²¹ The government has expressed its intention to appeal Judge Kaplan's order.

The Outrageous Government Conduct Doctrine

The Due Process Clause protects an individual against the exercise of power without any reasonable justification in the service of a legitimate governmental objective.²² To constitute a Due Process violation, the conduct of the government actor must "shock the conscience."²³ The

"shocks the conscience" standard, sometimes referred to as the "outrageous government conduct" standard, is necessarily imprecise.

The "outrageous government conduct doctrine" derives from *United States v. Russell*,²⁴ where the Supreme Court observed in dictum that facts could be presented where "the conduct of law enforcement agents is so outrageous that due process principles would absolutely bar the government from invoking judicial processes to obtain a conviction." *Id.*

Seizing on this dictum, the defendant in *Hampton v. United States*²⁵ alleged entrapment by government agents and attempted to construct an outrageous misconduct defense rooted in the Due Process Clause. This claim was rejected, but the resulting plurality opinion of the Supreme Court served to legitimize "outrageous government conduct" as a viable defense to criminal charges. Today, circuit courts recognize a defense to prosecution where the government violates a protected right of the defendant and the government's conduct is sufficiently "outrageous" to "shock the conscience."²⁶ Not all circuit courts recognized this defense; notably the Seventh Circuit does not consider dismissal an appropriate remedy for government misconduct, particularly in the absence of a showing of prejudice.²⁷

Concepts such as "fundamental fairness" and "universal sense of justice" are necessarily vague and incapable of ready definition. One circuit court aptly observed that what government behavior reaches a "demonstrable level of outrageousness" to constitute a due process violation is "at best elusive."²⁸ While this may be true, a consistent theme emerges from analysis of cases following *Russell* and *Hampton*. Due Process violations are found only in cases where government actors have employed physical or psychological coercion against the defendant. As the Second Circuit observed in *United States v. Chin*,²⁹ the type of conduct so extreme as to "shock the conscience" includes primarily "[e]xtreme physical coercion" or "torture"

that is "brutal and offensive to human dignity."³⁰ The Supreme Court's decision in *Rochin v. California*,³¹ is often cited as the paradigmatic example of government conduct that "shocks the conscience." In that case, police officers broke into the defendant's bedroom, attempted to pull drug capsules from his throat, and finally forcibly pumped his stomach to retrieve the capsules.

Dismissal of a criminal indictment for outrageous government conduct is rare.³² Since the Supreme Court first recognized the defense, *United States v. Tignor*³³ -- a case involving entrapment and government over-involvement in crime, -- is the only federal appellate decision to grant relief to a criminal defendant on the basis of outrageous misconduct. The historical record makes it clear, therefore, that the outrageous misconduct defense is rarely successful. Despite the paucity of cases finding government misconduct so severe as to constitute a due process violation, the doctrine remains a viable one.³⁴

In *Stein*, Judge Kaplan's order of dismissal was premised on finding both a due process and a Sixth Amendment violation.

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Like two constitutional tectonic plates resting on one another for mutual support, the court found the government's conduct in the KPMG prosecution to have upset the balance of each constitutionally protected interest.

Although *Stein III* does not rest solely on the finding of "outrageous government conduct," this finding is sufficiently significant and unusual to warrant separate consideration.

Judge Kaplan's Finding That The Prosecutors' Conduct "Shocked the Conscience"

In *Stein I*, the court concluded that the actions of the individual AUSA's "were part and parcel of the deprivation of the KPMG Defendants' rights to substantive due process that was inherent in the Thompson Memorandum."³⁵ In *Stein III*, the court went further, finding that the conduct of the AUSA's "shocked the con-

science," fitting their conduct into what a standard that the "*ne plus ultra* . . . of subjectivity."³⁶ The court based this finding on its conclusion that the prosecutors both pressured KPMG to withhold legal fees and used their power over KPMG to obtain proffers from KPMG employees:

Just as prosecutors used KPMG to coerce interviews with KPMG personnel that the government could not coerce directly, they used KPMG to strip any of its employees who were indicted of means of defending themselves that KPMG otherwise would have provided to them. Their actions were not justified by any legitimate governmental interest. Their deliberate interference with the defendants' rights was outrageous and shocking in the constitutional sense because it was fundamentally at odds with two of our most basic constitutional values - the right to counsel and the right to fair criminal proceedings.³⁷

The district court buttressed its findings by concluding that the government's conduct was "shocking" because it reflected a "deliberate indifference" to the KPMG Defendants' constitutional rights.³⁸

Judge Kaplan further found that the government's improper conduct negatively affected the KPMG defendants by forcing certain defendants to terminate

lawyers they could no longer afford and by forcing all defendants to budget trial preparation. KPMG's decision to cut off legal fees limited or precluded their attorneys' ability to review documents produced by the government in discovery, prevented

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them from interviewing witnesses, caused them to refrain from retaining expert witnesses, and/or left them without information technology assistance necessary for dealing with the mountains of electronic discovery.³⁹ These findings supported the court's conclusion that both the Fifth and

Sixth Amendment rights of the defendants were irretrievably impacted such as to deprive the defendants of fair process and the possibility of a fair trial.


Did the KPMG Prosecutors' Conduct "Shock the Conscience"?

Up until now, the rare finding of "outrageous government conduct" that "shocks the conscious" has been confined to cases involving physical or psychological coercion, or torture so extreme as to be considered offensive to human dignity. Judge Kaplan's decision in *Stein* serves as an unprecedented extension of the reach of this defense. Previously, in cases where Sixth Amendment violations were found, dismissal was not ordered. For example, in *United States v. Gonzalez*,⁴⁰ the Supreme Court found that the defendant's conviction was infected by structural error when the defendant was denied counsel of choice. Nevertheless, the court ordered reversal of the conviction and a new trial, not dismissal. Similarly, in *United States v. Williams*,⁴¹ the second circuit found that, owing to the government's conduct, the defendant was denied effective assistance of counsel but declined to dismiss or even reverse the conviction.⁴¹

The one case in which dismissal was ordered is readily distinguishable. In *United States v. Marshank*, the government employed defense counsel to identify

and target the defendant and then used the defense attorney to cajole his client into giving incriminating statements.⁴² Almost all the information used to indict the defendant in that case came from an individual acting as the defendant's own lawyer. Under those circumstances, the district court held, the government's conduct "infected every part of the investigation and prosecution" and it was "simply impossible to excise the taint."⁴³ *Stein* does not present equivalent facts.

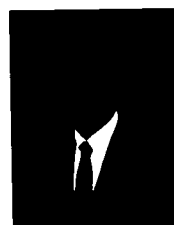
On appeal, the Second Circuit will have to grapple with the difficult question of whether government conduct that serves

to deprive a defendant of a bottomless war chest with which to defend a massive white collar case rises to misconduct of constitutional dimension. Lurking in the interstices of this case are even more difficult questions concerning the obligations of a corporation to absorb massive legal costs of those alleged to have injured the corporation even when there is no legal obligation to do so.⁴⁴ The issue of whether the availability of limited resources to defend a complex case necessarily implicates concerns about the effectiveness of the defense. Does all conduct by the government that serves to deprive a defendant of resources to mount a vigorous defense implicates constitutional concerns?⁴⁵ Is consideration of a corporation's payment of legal fees of employees accused of wrongdoing necessarily improper? Are there policy concerns that serve to promote corporate integrity and prevent corporate wrongdoing where partners and employees are aware they might have to exhaust their savings and fund their own defense if they engage in criminal conduct? These are but a few of the questions implicated in the *Stein* opinions and likely to be addressed by the Second Circuit. 



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