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HAS THE GOVERNMENT'S THUMB BEEN LIFTED FROM THE SCALES OF JUSTICE?

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For corporate America and the white collar criminal defense bar, the collapse of Enron in 2001 seemed to tilt the scales of justice in the Government's favor. President Bush announced a war on corporate crime spearheaded by a Corporate Fraud Task Force designed to function as a "financial crimes SWAT team."[1] Congress hastily enacted the Sarbanes-Oxley Act of 2002,[2] which not only mandated increased corporate disclosure, but also created new criminal offenses, enhanced sentences for existing offenses, and instructed the United States Sentencing Commission to increase sentencing ranges for financial fraud cases.

This atmosphere emboldened prosecutors. It was not uncommon for defense lawyers to hear prosecutors rebuff pleas for leniency by saying, "In light of Enron, I'd be happy to take this case to any jury. They will be outraged by this conduct and will certainly convict your client." An executive facing a financial fraud charge had little reason for optimism, either at the charging stage, at trial or at sentencing.

Fortunately, however, the imbalance may have started to change (notwithstanding the Lay and Skilling guilty verdicts), possibly resulting in a shift towards a more equitable balance. The most significant development is the June 2006 decision by United States District Judge Lewis Kaplan of the Southern District of New York,[3] holding that the Government's attempts to limit a corporation's advancement and indemnification of attorneys fees for its employees by making that decision a factor in its charging considerations – a tactic expressly authorized by the so-called Thompson Memorandum[4] – violate the employees' constitutional rights.

The shift appears to have begun with the post-conviction developments in the Arthur Andersen case. As a result of its conviction in 2002 on obstruction of justice charges, the accounting firm was forced to close its doors, throwing 28,000 people out of work.[5] Although the United States Supreme Court reversed the conviction of Arthur Andersen,[6] it could not resurrect the business.

The corporate "death penalty" resulting from the Arthur Andersen conviction prompted the Department of Justice ("DOJ") to review its charging policies. Instead of bringing charges against corporate entities, the DOJ began to enter into non-prosecution or deferred prosecution agreements. Bank of New York and HealthSouth Corporation were the beneficiaries of non-prosecution agreements with the DOJ, while among the most notable deferred prosecution agreements are those that the DOJ has entered into with Computer Associates, AOL and KPMG.

Over the past few months, there have been a number of developments that suggest that the scales of justice may be returning to a state of equilibrium. Despite the recent Enron convictions,

other juries have failed to convict executives charged with financial wrongdoing. HealthSouth founder and Chief Executive Officer Richard Scrushy was acquitted in June 2005 of all charges of corporate fraud. Juries on two separate occasions were deadlocked on whether former Cendant Chairman Walter Forbes fraudulently inflated corporate income, resulting in successive mistrials. Similarly, separate mistrials were declared in a case involving charges of illegal kickbacks against Tenet HealthSystem and its CEO. In addition, federal courts have found that the Government has impermissibly linked SEC and criminal investigations, depriving individuals of their constitutional rights. The cases of *United States v. Scrushy*, 366 F. Supp.2d 1134 (N.D. Ala. 2005) and *United States v. Stringer*, 408 F. Supp.2d 1083 (D. Ore. 2006) will be discussed later in this article.

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Government Conduct Discouraging Advancement of Employee Legal Fees Held Unconstitutional

The most stunning example of the heightened scrutiny being given to the Government's tactics is the June 2006 decision by Judge Kaplan in *United States v. Stein*, holding that the Government's imposition of the Thompson Memorandum provision obliging prosecutors to consider a corporation's advancement of attorneys fees in assessing its cooperation violates the Due Process Clause and the Sixth Amendment right to counsel. Judge Kaplan found that the Government had impermissibly altered the system of justice: "Those who commit crimes – regardless of whether they wear white or blue collars – must be brought to justice. The government, however, has let its zeal get in the way of its judgment. It has violated the Constitution it is sworn to defend."[7]

The decision was entered in the prosecution of KPMG employees and other professionals arising out of allegedly illegal tax shelters. In granting the hearing on the defendants' claims that the Government had violated their constitutional rights by wrongfully pressuring KPMG to refuse to advance their defense costs,[8] the Court focused on whether the Government impermissibly put its "thumb on the scale" of justice in influencing KPMG's determination of whether to indemnify its employees.[9] It condemned the Government's conduct, calling it a "shameful," possibly unconstitutional, interference.[10] Various industry associations weighed in to argue that the Government should not take a company's attorneys fees indemnification policy into account in making prosecutorial decisions.[11]

The Court telegraphed its leanings in a preliminary order that suggested it was seeking to identify a legal basis to hold the Government accountable. Prior to its decision it invited the parties to address whether there was a contract implied in fact between KPMG and the defendants for the advancement or indemnification of legal fees.[12]

In its ultimate opinion, however, the Court did not rule on KPMG's contractual obligation to advance attorneys fees. The Court opined that it was "quite possible" that all of the defendants had contractual and other legal rights to advancement of legal costs,[13] citing state law which authorized KPMG to indemnify its partners and employees, and placing emphasis upon KPMG's "unbroken track record" of doing so in the past. However, the Court found no need to decide that issue. Rather, in a hard hitting analysis, the Court found that (a) the right to fairness in criminal proceedings is a fundamental liberty interest subject to substantive due process protection; (b) the Government interfered with the process by pressuring KPMG to depart from its long-standing policy of paying legal fees, and this interference impinged upon the defendants' ability to defend themselves; (c) the Government's interference, and the Thompson Memorandum provision that authorizes it, do not withstand a strict scrutiny[14] analysis; and therefore (d) the Government's conduct and the Thompson Memorandum violate the defendants' rights to procedural and substantive Due Process.[15]

Despite finding violations of Constitutional magnitude, the Court did not dismiss the indictment. Rather, reasoning that the defendants can be restored to the position they would have occupied but for the Government's interference, the Court invited the defendants to bring a lawsuit against KPMG for the payments of their legal costs, over which the Court offered to exercise its ancillary jurisdiction. The Court provided the defendants a roadmap for the simplest means to do so, suggesting that they sue KPMG for declaratory relief and that they request an expedited hearing. On July 10, 2006, the defendants took the Court up on its offer, filing a civil suit against KPMG which was assigned to Judge Kaplan as a related case.[16]

Simultaneously with the KPMG case, Judge Paul Barbadoro of the District Court of New Hampshire was confronting the same issue. In *United States v. Gagalis*,[17] five former executives of

Enterasys Networks Inc. filed a motion asking the Court to dismiss the indictment based upon allegations of governmental misconduct, including the claim that the Government had impaired their right to counsel by interfering with the advancement of attorneys fees by the company.[18] The hearing had barely commenced before counsel for the corporation advised the Court that the company had agreed to pay the attorneys' fees.[19] That, however, did not end the matter. The Court currently has *sub judice* the defendants' contention that the Government improperly interfered with the *cooperating witnesses'* rights to advancement of their litigation expenses, thereby exchanging lenient plea bargains for specified testimony against the defendants.[20]

Challenged Government Conduct: Coordination of Civiland Criminal Investigations

In addition to the spotlight on the advancement of attorneys fees, two federal courts have placed scrutiny on the improper coordination of criminal and civil investigations by the DOJ and the SEC. In *United States v. Scrushy*, HealthSouth founder and Chief Executive Officer Richard M. Scrushy was the subject of parallel DOJ and SEC investigations.[21] The Northern District of Alabama found that the two agencies had improperly merged their investigations to such a degree that using Scrushy's deposition from the SEC's civil investigation would "depart from the proper administration of justice."[22] As a result, the Court excluded the use of the deposition in the SEC case and dismissed with prejudice the criminal perjury charges based upon the deposition testimony. In harshly condemning the Government's conduct as "cloak and dagger activities," the Court noted that: (1) the SEC moved the location of Scrushy's deposition at the DOJ's request in order to establish venue for the criminal perjury case; (2) the DOJ gave direction to the SEC regarding the topics to be examined at the deposition; (3) the SEC knew about the criminal investigation and did not inform Scrushy at the time of his deposition that federal prosecutors had targeted him as a defendant; and (4) the SEC participated in the criminal investigation. The Court rejected out of hand the Government's contention that it did not lie to Scrushy about the existence of the criminal investigation, holding that it could not take such a "limited view" of bad faith. The *Scrushy* decision stands as a warning that the boundaries between parallel investigations must be maintained, and that Government actors may not, in their zeal, corrupt the integrity of those boundaries.

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While the remaining counts of the *Scrushy* case went on to trial (where Scrushy was ultimately acquitted in June 2005 of all charges of corporate fraud), in *United States v. Stringer*,[23] the District Court of Oregon dismissed an entire indictment because of improper Government behavior. In *Stringer*, the DOJ obtained access to the SEC's investigative files of the defendants, former executives of FLIR Systems, Inc., including documents and a memorandum setting forth the SEC's legal and factual analysis. The DOJ held its own criminal investigation in abeyance while the SEC interviewed the defendants and other witnesses, and then utilized those interviews to further its criminal case. The DOJ was integrally, but secretly, involved behind-the-scenes with the civil investigation. In dismissing the criminal case, the Court focused on the fact that the DOJ advised the SEC how to create the best record for a perjury prosecution, arranged with the SEC to locate interviews in order to establish optimal jurisdiction for the DOJ, and received documents that the SEC had obtained in its civil discovery. The SEC participated in the subterfuge, taking steps to ensure that the defendants did not learn about the DOJ's involvement, and evading a direct question from Stringer's attorney about whether it was working with the DOJ when Stringer was subpoenaed to testify before the SEC. In the face of this deceit and trickery by both the DOJ and the SEC, the Court held that the Government's tactic of using the SEC civil investigation to develop evidence for the criminal investigation violated the defendants' due process and Fifth Amendment rights. The Court therefore dismissed the indictment.

While the precise boundary beyond which parallel proceedings improperly merge is necessarily a fact-based analysis, these two decisions give hope that the courts will conduct a searching inquiry of those facts in order to ensure, in Judge Kaplan's words, that the Government's thumb is not "on the scale."[24]

Other Challenged Government Conduct

Earlier this year, in January, there was another glaring example of judicial skepticism concerning the Government's conduct of its investigations. In oral argument before the Second Circuit, ex-WorldCom chief Bernard Ebbers sought to have his fraud and conspiracy convictions overturned on the grounds that the Government deliberately classified three witnesses as "subjects"[25] under investigation, in an effort to keep them from testifying.[26] Under questioning by the Court, the Government was forced to admit that the Government had not actively investigated the three since the start of Ebbers' trial. This response prompted Circuit Judge Barrington Parker to remark that the investigation of the three fell into a "black hole" which could "eviscerate the case law on unavailability [of witnesses], and the [Government's] ability to manipulate could become problematic."[27] The Second Circuit has not issued its ruling as of this writing.

In another example of the judiciary's concern about the Government's unfettered prosecutorial discretion, the Second Circuit held that the Government did not have the exclusive say as to whether a defendant's cooperation was an appropriate factor to consider at sentencing. In *United States v. Fernandez*,[28] the defendant provided information that led to the arrest of her co-conspirator. The Government declined to offer the defendant a cooperation agreement, claiming that the information on its own was insufficient to support the arrest and citing certain subsequent behavior of the defendant. Nonetheless, the defendant sought a reduction based upon the information that she had provided. The Second Circuit affirmed the district

court's refusal to reduce the defendant's sentence on that account. However, the Court emphasized that a court may take into account a defendant's efforts to cooperate even if the Government fails to apply for a downward departure under U.S.S.G. § 5K1.1. The Court coined the phrase "non-5K cooperation" to cover this type of conduct. While it remains to be seen whether, as a practical matter, a defendant can receive credit for cooperation without the Government's acquiescence, such a defendant may now urge consideration of a factor previously thought to be within the Government's exclusive province.

The Second Circuit also endorsed the decision of a district court in *United States v. Cassese*,[29] which set aside a jury verdict in which the defendant, the Chairman and President of Computer Horizons Corporation, was convicted of insider trading in connection with a tender offer. Both the trial court and the Second Circuit disagreed with the jury's interpretation of the evidence of willfulness, finding that each of the areas of proof by the Government was characterized by "modest evidentiary showings, equivocal or attenuated evidence of guilt or a combination of the three." Without reaching the question of whether the Government was required to prove that the defendant knew that the nonpublic information pertained to a tender offer, the Court ruled that the Government failed to carry its burden even if willfulness only required proof that the defendant generally understood the unlawfulness of his actions.

Finally, after months of hearings, the United States Sentencing Commission in April of this year unanimously voted to strike language from the Federal Sentencing Guidelines providing that, where necessary to provide complete disclosure, corporations were required to waive attorney client privilege and work product protections in order to receive credit for their cooperation – a tool that prosecutors have been using to press for waiver of these privileges. Overturning this guideline does not change DOJ guidance which, since the 1999 Holder Memorandum,[30] factor in a corporation's waiver of attorney client and work product privileges in determining a corporation's cooperation. Nor does it alter similar guidelines employed by the SEC[31] and other investigatory branches of the federal government. However, it does ensure that federal prosecutors cannot cite a corporation's refusal to waive these privileges as a basis to penalize a corporate defendant at sentencing – a welcome constraint on this extraordinarily controversial tool.

Conclusion

While each of these examples may represent only a small fraction of the many and varied Government investigations and prosecutions occurring on a daily basis – and may constitute extreme examples at that – nonetheless they provide the hope that the judiciary will continue to critically assess Government conduct with an eye towards reestablishing a level field. The system of justice requires no less than the standard that Judge Kaplan articulated in *Stein*: "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."[32] Where defendants and their attorneys have the resolve to fight against the Government's thumb on the scale, these cases demonstrate that the courts will not stand idly by, but will pry it off and restore the balance.

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FOOTNOTES

1 *President Announces Tough New Enforcement Initiatives For Reform: Remarks by the President on Corporate Responsibility, Regent Wall Street Hotel, July 9, 2002 (White House Office of the Press Secretary).*

2 15 U.S.C.S. §§ 7201, *et seq.*

3 *United States v. Stein*, No. 05 Cr. 888 (S.D.N.Y. June 26, 2006) (Opinion).

4 The Thompson Memorandum can be found at the following link: www.usdoj.gov/dag/cftf/business_organizations.pdf. Section VI(B) authorizes prosecutors to consider "a corporation's promise of support to culpable employees and agents . . . through the advancing of attorneys fees . . . in weighing the extent and value of a corporation's cooperation."

5 *See* Court Overturns Arthur Andersen

continued

Conviction, CBSNews.com, June 1, 2005.

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

7 *United States v. Stein, supra,* June 26, 2006 Opinion at 3.

8 In one example cited by the defendants, the Government threatened to examine "under a microscope" KPMG's decisions about advancing fees. *United States v. Stein, supra,* Defendants' (Amended) Pre-Hearing Memorandum, filed May 7, 2006.

9 *United States v. Stein, supra,* Hr'g Tr. at 23, line 18, March 30, 2006.

10 *United States v. Stein, supra,* Hr'g Tr. at 31, lines 5-8, March 30, 2006.

11 *Id.*, Notice of Amended Motion of the Securities Industry Association, the Association of Corporate Counsel, the Bond Market Association and the Chambre of Commerce of the United States of America for Leave to File Brief Amici Curiae, filed May 3, 2006; Supplemental Brief for Amici Curiae, filed May 22, 2006; *see generally* Mark Hamblett, *Briefs Reflect High Stakes In Fight Over KPMG's Attorney Fee Policy*, N.Y.L.J. May 25, 2006.

12 *United States v. Stein, supra,* May 11, 2006 Memorandum and Order.

13 *United States v. Stein, supra,* June 26, 2006 Opinion at 38.

14 The Court was able to employ a strict scrutiny analysis based upon its premise that a defendant's right to obtain "defense resources lawfully available to him" free from government interference is a fundamental right. *United States v. Stein, supra,* June 26, 2006 Opinion at 47.

15 In an analysis that lacks the extensive discussion characterizing the Due Process claim, the Court also found that the Government had violated the defendants' Sixth Amendment right to counsel. The Court rejected the Government's contention that the defendants had no "right" to spend KPMG's money, finding that the defendants had the right to expect that their expenses would be paid for. *United States v. Stein, supra,* June 26, 2006 Opinion at 57.

16 *In re: United States of America*, No. 06 cv. 5007 (S.D.N.Y. docket opened June 29, 2006).

17 *United States v. Gagalis*, Case No. 04 Cr. 00126 (D.N.H.).

18 *Id.*, Defendants' Corrected Emergency Motion For Relief And Sanctions For Government's Interference With Defendants' Fifth And Sixth Amendment Rights, filed February 22, 2006.

19 *See* Nathan Koppel, *United States Pressures Firms Not to Pay Staff Legal Fees*, Wall St. J. March 28, 2006.

20 *United States v. Gagalis, supra,* Defendants' sealed motion, filed March 22, 2006; Government's Response to Defendants' Supplemental Memorandum, filed April 20, 2006; Reply Memorandum in Support of Defendants' Supplemental Memorandum of Law, filed May 4, 2006.

21 *United States v. Scrushy*, 366 F. Supp.2d 1134 (N.D. Ala. 2005).

22 *Id.* at 1140.

23 *United States v. Stringer*, 408 F. Supp.2d 1083 (D. Ore. 2006).

24 In what may be a hopeful example of self policing, four days after the Second Circuit vacated criminal obstruction and witness tampering convictions of Frank Quattrone due to improper jury instructions in *United States v. Quattrone*, 441 F.3d 153 (2d Cir. 2006), the SEC itself acted to remedy a sanction that resulted from improperly merged investigations. Quattrone had been banned from the securities industry for life by the National Association of Securities Dealers when he refused to testify before the NASD concerning the same set of facts that gave rise to the DOJ's criminal investigation. Quattrone asserted his Fifth Amendment right against self-incrimination before the NASD, and asked for a delay in the proceedings until the criminal proceedings related to the obstruction charges were resolved. The NASD hearing panel suspended Quattrone for one year for his refusal to testify and, after the NASD and Quattrone both appealed, the NASD's National Adjudicatory Panel ordered a lifetime ban, which Quattrone appealed to the SEC. Quattrone argued that the involvement of the NASD in a joint investigation with the SEC required that the Fifth Amendment be held applicable to the NASD's request for information. The SEC agreed that, because of the NASD's extensive participation in the SEC's investigation, there was a genuine issue of material fact as to whether the NASD's request for information constituted "state action" which would give Quattrone a right to refuse to respond under the Fifth Amendment, and set aside the ban. *In the Matter of the Application of Frank P. Quattrone*, Opinion of the Commission, Rel. No. 53547, Admin. Proc. File No. 3-11786 (March 24, 2006).

25 A "subject" of an investigation is a person whose conduct is within the scope of the grand jury's investigation. United States Attorney's Manual, Title 9, § 9-11.151.

26 *See, e.g.*, Brooke A. Masters, *Ebbers's Prosecutors Questioned on Tactics*, Washingtonpost.com, January 31, 2006.

27 *Id.*

28 *United States v. Fernandez*, 443 F.3d 19 (2d Cir. 2006).

29 *United States v. Cassese*, 428 F.3d 92 (2d Cir. 2005).

30 Memorandum Regarding Federal Prosecutions of Corporations, United States Deputy Attorney General, Eric H. Holder, Jr., §§ III-IX (June 16, 1999). The Thompson Memorandum ratified the Holder Memorandum and added additional factors to be considered in making prosecutorial decisions concerning business entities, with an "increased emphasis on and scrutiny of the authenticity of a corporation's cooperation." *See* footnote 6.

31 The so-called "Seaboard Report," formally known as Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Securities Exchange Act of 1934 Release No. 44969 (October 23, 2001).

32 *United States v. Stein, supra,* June 26, 2006 Opinion at 82.