Advancing Fees for Corporate Officers, Directors and Employees

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CRIMINAL JUSTICE

By Robert Sanger

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ADVANCING FEES FOR CORPORATE OFFICERS DIRECTORS AND EMPLOYEES

INTRODUCTION

Corporate counsel first read the Thompson Memo[1] in 2003; then there was the kinder and gentler but still scary McNulty Memo in 2006.[2] The Memos issued by the United States Department of Justice (DOJ), by the Deputy Attorney Generals of those names in office at those particular times, were entitled, "The Principles of Prosecution of Business Organizations." The Thompson Memo raised the issue of when a corporation or other business entity can be punished for not cooperating with the government and what the government expects the corporation to do to gain credit for cooperating. The Big Brother aspect of "cooperation" was addressed by commentators and many issues were litigated. The DOJ in the McNulty memo, as well as the United States Sentencing Commission,[3] made significant concessions between 2003 and 2006 by backing off some of the harsher language relating to what should be the delicate issue of attorney-client relationships in determining whether a corporation is to be punished for not cooperating with a criminal investigation.

The precise issue addressed in this month's *Criminal Justice* column is whether or not the advancement of attorneys fees by a corporation for its officers directors and employees can be taken into account by the federal prosecutors in determining whether or not to indict a corporation. Before Thompson, most corporate business counsel would not think twice about making sure that their officers and directors and key employees were represented when the federal investigators came knocking and many would have extended this to all employees who were subjects or targets of the investigation.[4] After all, California law provides for indemnification for legal expenses and it just makes good business sense to make sure that everyone is properly represented by competent white collar defense counsel.

While it remained the advice of many corporate counsel and criminal practitioners to provide funds for counsel, the Thompson Memo put pressure on corporations not to do so. In essence, the government put the corporate world on notice that it would look at corporations advancing fees for counsel for individuals in its organization as a part of their filing decision in deciding whether to indict.. We have argued over the years, since the promulgation of the Thompson Memo, that this pressure was in direct conflict with California law as well as the law of many other jurisdictions and that it was an unconstitutional interference with the basic right to counsel.

The Court of Appeals for the Second Circuit has now provided authority for this very position. The case of *United States v. Jeffrey Stein* was decided on August 28, 2008.[5] The Court of Appeals upheld a District Court dismissal of a group of accountants at KPMG who had been indicted on federal fraud charges. In so doing,

the Second Circuit took significant pressure off of corporate counsel and business lawyers. In this month's column, we will look at the thompson and McNulty Memos, the decision in *U.S. v. Stein* and the implications of all of them for advising corporations and other employers.

CORPORATE CRIMINAL INVESTIGATIONS

As all corporate counsel know, criminal investigations are almost a way of life for major corporations. We have discussed this here in previous *Criminal Justice* columns. Over the years, we have seen a dramatic increase in the number of such investigations. Furthermore, it is no longer just the heavily regulated industries and the larger corporations which find themselves under criminal investigation. Federal Special Agents have proliferated and criminal investigation divisions are a part of almost every federal agency. As a result, all corporate counsel have to be prepared for some agent, somewhere, to call on the corporate client or individual employees; to serve a grand jury subpoena on the client's bank account; or to execute a series of search warrants.

Corporate counsel (by which I mean to include all business lawyers advising all forms of business entities whether in-house or outside counsel) have become aware of the drill associated with the first sign of a criminal investigation. Corporate criminal investigations are critical and documentation of proper policies and procedures for dealing with alleged wrongdoing can be extremely important in deflecting or mitigating corporate criminal liability. Without going into detail here – this is subject for a separate book – making correct choices and having proper procedures in place before a criminal investigation starts and implementing them as soon as an issue arises can be the difference between corporate life and death. There is no "one size fits all" and each situation has to be confronted with all options in mind.

One critical corporate response to a criminal investigation, however, may be to defend on the merits. It should be no big surprise that the government is not always right when it steps (or charges) forward to investigate or accuse. It is often in the best interests of the corporation to make sure that the officers and directors as well as key employees who are subjects or targets to have proper criminal counsel. This may be especially true in smaller, closely held corporations where these key people "are" the corporation. The subject or target of these investigations is almost always

not only the corporation but the individuals who own or run it or make key decisions. Despite the language of the Thompson and McNulty Memos -- which were written for prosecutors by prosecutors -- corporations and individuals accused by the government still have the constitutional right to defend themselves.

Proper legal representation of the key individuals and the corporation itself can be critical to warding off unfounded indictments. In addition, having competent white collar defense counsel in place makes for a more efficient, more organized defense for all concerned. The resources of the government are almost boundless. Coordination of defense resources between lawyers for the corporation and the individuals, consistent with ethical and legal responsibilities, may be the only rational way to defend. It is critical for criminal defense counsel to get in on the ground floor pre-indictment where there is still an opportunity to persuade the agents or the United States Attorneys Office (USAO) not to prosecute.

It is also critical, if indictment cannot be avoided, that these same criminal defense lawyers have had this additional pre-indictment time to prepare. Federal criminal investigations usually take many months and sometimes years. During that time the prosecutors and agents are investigating, reworking and refining their case. If lawyers are retained by or appointed for defendants only once there is an indictment, these new players are faced with the Speedy Trial Act and often an overwhelming mass of documents that the government has had since the beginning.

THE CORPORATIONS STATUTORY OBLIGATION TO PROVIDE COUNSEL

In California, the choice of a corporation to provide counsel for its officers directors and all employees is made easier by virtue of California Corporations Code Section 317 and Labor Code Section 2802. These statutory provisions in combination require that an employer may indemnify in some circumstances, and must in others, an officer, director, employee or agent for all legal expenses incurred in discharging their duties within the course and scope of their employment. The Corporations Code specifically provides that it is a proper expenditure of corporate funds to advance the funds for these purposes after following certain requirements.

Consistent with the public policy enunciated by these codes sections, corporations often advance attorneys fees on behalf of officers, directors and employees when a criminal investigation comes to their attention. Many federal white collar prosecutions are not targeting a rogue employee[6] but they are after the key employees, officers and directors of corporations for what they deem to be illegal business practices. These business practices may be defensible and the competent representation of each of the individuals and the corporation will be the best way to defend all involved. In addition, most of these white collar cases are fact and document intensive, often involving tens of thousands to millions of documents. Having a competent team of experienced white collar defense lawyers representing everyone makes it easier to reach agreements for information sharing and division of labor.

Unfortunately, if the corporation does not advance fees, particularly in the more complicated cases, individuals may not have the financial ability to pay for competent defense counsel and to hope that they can prevail on their employer for indemnification after the fact. The actual result we often see is either individuals going unrepresented pre-indictment or the arrival of lawyers who may have good intentions and may be willing to charge less because they are a friend of a friend but who do not have the level of expertise or resources necessary to a major white collar defense. In the long run, this can cost the corporation much more, both directly and indirectly, than if it had advanced fees for competent white collar criminal defense counsel and injustice can be done.

THE THOMPSON AND McNULTY MEMOS

From the government's standpoint, policy makers at the DOJ or other federal agencies have long been suspicious of a corporation hiring counsel for its officers, directors and employees. We have seen extreme measures in some cases where the government agency obtains a temporary restraining order in a parallel civil matter freezing all assets or where there is a forfeiture action commenced concurrently essentially rendering the defendants financially unable to afford food let alone a lawyer. These tactics may be a reflection of a sincere belief that assets necessary for restitution may be jeopardized or may, in part, be a refection of a desire on the part of some policy makers to keep subjects and targets from hiring counsel particularly at an early stage..

It might also be a reflection of the DOJ's concerns that the hiring of counsel may result in the defendants taking unfair advantage to "collude" in a defense. In this regard, we have seen efforts in years gone by to characterize joint defense agreements among the various defendants' counsel as obstructions of justice. There have also been efforts to get around counsel for individuals in order to convince the individuals to turn against the corporate targets or other defendants.

This sense of the government attempting to keep individuals from being vigorously represented by competent white collar defense lawyers comes through loud and clear in the Thompson Memo. The government's position is that a corporation which hires counsel for it guilty employees ought to be indicted and treated harshly. On the other hand, according to the Memo, if the corporation does not want to be indicted, it should be a good citizen and turn in all its wrongdoing employees. The corporation is not being a good citizens if it does not fully cooperate with the federal investigators, if it does not waive attorney client privilege and if it is so bold as to advance fees for the individual who are subjects or targets.

The premise behind this, as with other government theories when it is suggested that we do not need our constitutional rights, is that when the government chooses to prosecute it is infallible. Yet, in reality, we have had many cases where proper and vigorous representation of the corporation and the individuals has led to the realization by the government that the allegations were unfounded resulting in a declination to prosecute. Assistant United States Attorneys (AUSA's) actually prosecuting cases do not want to prosecute if there is really no case. Yet, the DOJ at the level of policy may not clearly see how the Memo has a direct affect on skewing the process. Ultimately, proper representation not only benefits the accused but helps the government avoid the injustice of unwarranted indictments and prosecutions.

The effect of the Thompson Memo, even as modified by McNulty, is that there is an incentive for a company to agree to cooperate with the government during a criminal investigation and to violate its employees' rights, which are statutory in California, to the indemnification for legal expenses for matters within the course and scope of their employment. Although the tension over corporate self-preservation and employee's rights to be represented has persisted over a long time, the more recent demise of Enron and Arthur Andersen has caused corporations and their corporate counsel and criminal counsel to debate the risks and rewards of providing a strong defense for the individuals.

In most cases, especially where the criminal investigation involved business practices of the individuals which were accepted by the corporation, we would advise of the risks but urge that the corporation step up to the plate for the individuals. Nevertheless, the threat of retaliation against an employer for hiring counsel for the individuals was a risky and time consuming process. To its credit, the DOJ revised its policies in the McNulty Memo of 2006, particularly regarding the requirement of waiving attorney client privilege, and reworded the issue regarding the advancement of fees by the corporation for the individuals.

In Thompson, the DOJ said that "a corporation's promise of support to culpable employees . . . through the advancing of attorneys fees" could be considered in determining the extent of the corporation's cooperation. In McNulty, the DOJ said: "Prosecutors generally should not take into account whether a corporation is advancing fees to employees or agents under investigation or indictment." However, in a footnote, the DOJ says "In extremely rare cases, the advancement of attorneys fees may be taken into account when the totality of circumstances show that it was intended to impede a criminal investigation." But, in these cases, approval to consider this must be obtained from Main Justice and other rules apply.

While the language is better in McNulty, there is still concern about its chilling effect. Nevertheless, in California, where we have a statutory duty to indemnify, we have felt on solid ground generally advising that advancing fees for competent white collar criminal defense counsel is appropriate in most circumstances. We have maintained that, notwithstanding Thompson and whatever is meant in McNulty, there is a right to counsel and a right to mount a vigorous defense.[7] The Second Circuit has now given concrete support to that position.

UNITED STATES v. JEFFREY STEIN et al.

In *United States v. Stein*, __ F.3d ___ (2nd Cir. 2008), we have authority for the proposition that the government's policy of threatening corporations with indictment or harsher treatment if they hire counsel for individuals under the Thompson Memo violates the individuals' Sixth Amendment right to counsel and may violate their Fifth

Amendment rights as well. The Court, affirming the judgment of the District Court, found the government conduct so offensive that it concluded that dismissal of the action was the only proper remedy.

In *Stein*, the named defendant and his co-defendants were partners and employees of the major accounting firm of KPMG were investigated and eventually indicted for fraud related to what were characterized by the government as fraudulent tax shelter schemes. The government threatened to indict the firm itself for not cooperating if it encouraged the hiring of counsel by employees. In fact, KPMG and their counsel were persuaded to threaten employees that they would not pay their fees if the employees did not cooperate in providing interviews and further agreed to cap the fees of individuals in a way that would not permit a full and vigorous defense given the complexity of the case. KPMG then avoided indictment and entered into a deferred prosecution agreement whereby they would pay $456 million and agree to further cooperation in the prosecution of individuals.

The same day that KPMG entered into the deferred prosecution agreement, six of the individual defendants, including Mr. Stein, were indicted followed by another ten employees a couple of months later. As soon as the indictments were handed down, KPMG ceased to pay for the legal fees of the individuals pursuant to the Thompson Memo and fees policy demanded by the government.

The Court found that the implementation of the government's fee policy violated the Sixth Amendment because the individuals were deprived of their right to counsel of their choice. While there were technical issues to address, like when the right to counsel attaches and whether the policy and acts of the government interfered after the right attached, the decision stands pretty firmly for the proposition that the government cannot constitutionally interfere with the right to counsel by these kinds of coercive tactics. It made a point that these cases can be extremely complicated and require counsel to be familiar with literally millions of pages of documents. It is critical that the lawyer of choice, if she or he was retained, should not only work the case up pre-indictment but should be allowed to take the case through pre-trial and even trial if necessary

The lower court in *Stein* also upheld the claims of two of the defendants that their "cooperative" interviews had been coerced under the Fifth Amendment by virtue of

the Thompson Memo and the government's fee policies. The Second Circuit did not reach this issue as moot since dismissal of all of the indictments was affirmed on Sixth Amendment grounds. Nevertheless, that objection to this government conduct was not rejected.

CONCLUSION

With Stein in hand, corporate and criminal defense counsel no longer have to contend with the potential chilling effects of the Thompson and McNulty Memos when recommending the advance of fees for competent white collar criminal defense counsel for individuals whether officers, directors or employees. Unless it is a situation with a "rogue criminal" or some other factors apply, it is the best practice, under California statute and the federal Constitution, to consider advancing the fees necessary for the individual subjects or targets to investigate and defend properly.

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[1] http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm

[2] http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf

[3] See for instance, United States Sentencing Guidelines (USSG) Section 8C2.5(g) deleting a reduction in culpability score for a corporations waiver of the attorney-client privilege, effective November 1, 2006.

[4] There are three categories of people who are contacted by criminal investigators: witnesses, subjects and targets. A witness is a victim or an innocent observer of events. A subject is a focus of an investigation who may or may not end up being a target. A target is the person or entity regarding whom an indictment is intended to be sought.

[5] United States v. Stein ___F.3d ___, 2008 WL 3982194 (2nd Cir., 2008)

[6] For the sake of discussion, other considerations apply in the case of the rogue employee who has victimized the corporation as well as committed a public offense. While this may be hard to determine in some cases, the clear case, for instance, of a rogue employee talking personal kick backs on government contracts

without the knowledge and to the detriment of both the government and the employer would not give rise to either advance of legal fees or indemnification after the fact.

[7]It should be obvious that none of this is intended as legal advice to be relied upon in any particular case. Each case is different and other considerations my apply. However, this has generally been our position particularly in business practices cases and others where the conduct of the individuals in intertwined with the corporate liability. We do not suggest that any counsel should obstruct justice or do unethical or illegal acts in the representation of corporate or any other clients.