The Obstruction of Justice Department

BY ROGER DONWAY

During the last five years, U.S. government prosecutors have developed methods for stripping white-collar defendants—both corporate and individual—of their ability and willingness to mount a courtroom defense. One such method was pioneered during the case of Arthur Andersen, which formerly numbered among America's Big Five accounting firms. In March 2002 that firm was indicted on a single count of obstructing justice, and a *Wall Street Journal* story noted: "In the 212-year history of the U.S. financial markets, no major financial-services firm has ever survived a criminal indictment. Now, Arthur Andersen LLP will either make history—or be history." Of course, the firm did not survive, even though in 2005 the Supreme Court declared, unanimously, that the jury in the case had been wrongly instructed.

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The destruction of Arthur Andersen provided a demonstration of one mighty prosecutorial weapon. Simply by indicting a financial-services company, the government could so undermine the firm's reputation that it would collapse. What a jury might say about its guilt or innocence did not matter because the company could not afford to go to trial. To survive, it had to stave off indictment by doing whatever prosecutors commanded.

And that led to a second weapon, one that could be used against individual white-collar suspects. In July 2002 President George W. Bush established the Corporate Fraud Task Force and appointed Deputy Attorney General Larry D. Thompson to head it. In January 2003 Thompson issued a memorandum urging "increased emphasis on and scrutiny of the authenticity of a corporation's cooperation." Specifically, Thompson said, one "factor to be weighed by the prosecutor is 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, [as] through the advancing of attorneys fees . . . may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation."

This was very neat. A financial-services corporation must cooperate or die, and cooperation entailed not "supporting" employees who are somehow known to be culpable (prior to trial), for instance by advancing them the money they need to prove their innocence.

But surely, one might think, though the Thompson Memorandum opened up this potential for prosecutorial abuse, law-enforcement agents would never employ such powers to strip suspects of their best defense. Surely, prosecutors would say: "Let the adversarial system produce the truth." At any rate, surely, the sort of high-level prosecutors who carry out cases against top U.S. financial firms would not try to have defendants dragged into court financially bound and gagged.

For those who think so, the KPMG case is a revelation.

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Criminalizing Tax Advice

The case against KPMG has roots going back to the mid-1990s when the company (another of the Big Five accounting firms) was selling financial strategies that allowed Americans to lessen their tax payments. In 2002 the IRS began issuing summonses to KPMG, requesting documents that the firm claimed were protected under existing rules of confidentiality. That disagreement led to a certain amount of back-and-forth tugging between the firm and the IRS. In November 2003, however, a Senate subcommittee publicized the IRS case by holding hearings on "tax shelter abuse" and focusing on KPMG. Accommodatingly, the firm sent several people to present a defense, including its deputy chairman and chief operating officer, Jeffrey Stein; Richard Smith, vice chairman in charge of the tax division; and Jeffrey Eischeid, a partner in the personal financial planning division. Predictably, the men were excoriated and insulted by antibusiness senators. At the same time, PBS's *Frontline* helped feed the lynch-mob mentality by preparing an hour-long program on "bogus tax shelters," also focusing on KPMG. The show featured former IRS Commissioner Charles Rossotti saying: "Anything that's not being paid that should be paid, that's basically what the honest taxpayer is making up," as if "what should be paid" were somehow independent of a person's financial transactions and as if federal spending were an unalterable sum that had to be raised one way or another.

Charles Rossotti

All this negative publicity deeply troubled KPMG chairman and CEO Eugene O'Kelly. To deal with it he hired the law firm of Skadden Arps in January 2004, and particularly Robert S. Bennett, with the goal of setting KPMG on a course of public appeasement. Stein was allowed to "retire" with a three-year consulting contract, while Eischeid was placed on administrative leave and Smith was transferred out of the tax division.

Such was the situation when the IRS made a criminal referral regarding KPMG to the Justice Department, which passed it along to the U.S. Attorney's Office (USAO) for the Southern District of New York, where it was received on February 5, 2004. The USAO notified Skadden Arps, and a meeting was arranged for February 25. In the meantime, on February 9, the U.S. Attorney's Office prepared "subject letters," advising some 20 to 30 KPMG employees that they were persons "whose conduct is within the scope of [a] grand jury investigation." These letters were hand-delivered, with most arriving before February 20.

Some months later the *Wall Street Journal* would editorialize that this entire approach to KPMG's tax strategies was highly unusual and legally aggressive. Ordinarily "the IRS issues its point of view on a shelter, putting taxpayers who use it on notice. If the IRS then takes the taxpayer to court over the shelter, he has the chance to respond before a judge who makes a ruling and precedents are thus established." But "in this case, the IRS called in the prosecutors first. . . . No taxpayer has been brought to court over these shelters, and no judge has ruled on whether they 'work,' in the jargon of the tax-shelter business. . . .The KPMG case attempts to short-circuit the messy business of proving that a tax shelter is illegal by using the power of prosecution to target the tax advisers directly. . . . KPMG's partners in this case believed they were selling shelters that were entirely legal, and the underlying legality of those shelters has never been formally challenged. Yet the government has come down on those accountants and tax lawyers as if they belonged to the mob" (October 6, 2005). At the time, the *Journal*'s editorial writers did not know the half of it.

Betrayal

On February 18, in response to the government's "subject letters," KPMG CEO O'Kelly sent a memo to all partners assuring them that any "present or former members of the firm asked to appear will be represented by competent counsel at the firm's expense." At the February 25 meeting, however, lawyer Robert Bennett announced that KPMG's object was to save the firm, not to protect individuals. In a reference to the fate of Arthur Andersen, he noted that an indictment of KPMG would result in the firm's demise, leaving the country with only a Big Three in accounting. When

Bennett mentioned the subject of KPMG's paying legal fees, the government's lead attorney warned that "misconduct" should not be "rewarded." Another government attorney said that if the company was not legally bound to pay partners' fees but did, "we'll look at that under a microscope."

Following that meeting, KPMG abandoned its employees. It sent letters to targeted employees' lawyers, who were still being paid by the firm, saying that payments would cease if their clients were charged with criminal wrongdoing. In other words, contrary to what the firm's CEO had recently promised, there would be no money for legal defense. From that point on, government prosecutors pressed their advantage relentlessly. They notified KPMG whenever anyone had failed to comply with any of the government's demands, and KPMG duly notified that person's lawyer that his client had ten days to comply—after which legal fees would be terminated. When some people still failed to comply, they were fired. In the case of the firm's former deputy chairman, who had received a three-year consulting contract on being forced to leave the firm, KPMG suspended the contract unilaterally.

On August 29, 2005, in return for these and other actions, plus a fine of $456 million, the Department of Justice entered into a "deferred prosecution agreement" with KPMG, which meant that the department would drop all charges against the firm on December 31, 2006—if it continued to cooperate. Having thus made sure that indicted KPMG employees would be nearly helpless, the government's prosecutors proceeded to charge eight of KPMG's former employees, and the firm cut off all payment of their legal expenses. In October a superseding indictment accused 17 former KPMG employees and two outsiders of conspiring to defraud the IRS. The case—involving millions of documents and hundreds of depositions—was expected to cost any defendant rash enough to go to trial some $20 million.

Fighting Back

In January 2006 the KPMG defendants (several already insolvent) moved to have the charges against them dismissed on the grounds that the government had improperly interfered with KPMG's advancement of money for their legal bills. In March the government made its response, declaring that—Good Heavens!—it had no objection to KPMG's paying the defendants' legal expenses. Cutting them off had been entirely the firm's own decision, and the defendants (said the government) "cannot point to any evidence" indicating otherwise. In a letter to the court, a government attorney insisted that during the February 25 meeting "the Government did not instruct or request KPMG to implement that plan [not to pay legal fees] or to implement a contrary plan."

Government Impeded Defense

In June 2006 the judge overseeing the case, Lewis A. Kaplan, found that "it had been the longstanding voluntary practice of KPMG to advance and pay legal fees, without a present cap or condition of cooperation with the government, for counsel for partners, principals, and employees of the firm." This arrangement was a private matter between employer and employee, the judge noted, but the government had very purposely interfered with the firm's practice, and that was not a private matter. The U.S. judicial system rests on the premise that partisan advocacy on both sides of a case is the best assurance that the guilty will be punished and the innocent go free. Despite that, government prosecutors had, on the basis of the Thompson Memorandum, leaned on KPMG to hamper its employees' ability to mount their best defenses. "KPMG refused to pay because the government held the proverbial gun to its head." Such behavior undermined "the proper function of the adversary process" and thus violated the defendants' Fifth Amendment right to a fair trial and Sixth Amendment right to the assistance of counsel. Moreover, during the Court's hearing on the issue, Judge Kaplan remarked, "[T]he government was economical with the truth." Its assertion that it had not engaged in coercion and bullying "could be justified only by tortured definitions of those terms." Kaplan observed that he had seen people convicted of making false statements for assertions less misleading than those the government's attorneys had offered him.

In an attempt to keep the trial on track, Kaplan ruled that, were the defendants to sue KPMG for their fees, he would listen to the claims. But KPMG challenged Judge Kaplan's right to haul it into court over the fee dispute,

and the Second Circuit Court of Appeals sided with KPMG in May 2007. At the same time, the appeals court noted: "Dismissal of an indictment for Fifth and Sixth Amendment violations is always an available remedy."

Consequently, that was the course Judge Kaplan took. Six of the original defendants, he found, had not been wronged by government coercion. Two had never worked for KPMG; one had pled guilty; others were in various odd circumstances. But the remaining 13, he concluded, had indeed been deprived by the government of the ability they would have had to mount an adequate defense. And government attorneys had tried to deceive the Court into believing otherwise. That was intolerable. Last July 16, therefore, Judge Kaplan dismissed all charges against the 13. It was a drastic remedy, he acknowledged, but it was his only option.

Obstructing Justice

Since that day, lawyers and bloggers have debated the correctness of Judge Kaplan's ruling. Yes, say some, the Sixth Amendment guarantees people the right to "assistance of counsel," and this has come to mean that people have a right to assistance of counsel whether or not they can afford it. But that does not mean people have the right to legal representation that costs several million dollars.

Others say that misses the judge's point, and I think they are correct. The defendants did not have a constitutional right to mount a multimillion-dollar defense, only a contractual right. But given that they had a contractual right, they also had a constitutional right that the government not plot to deprive them of such a defense.

On joining KPMG the defendants acquired a legitimate expectation that their legal expenses would be advanced should they get into trouble with the law as a result of their jobs. That contractual expectation was reinforced by the assurances that CEO O'Kelly gave immediately after he became aware of the U.S. Attorney's investigation. One thing only—the government's threat to reduce KPMG to rubble—prompted the firm to deprive its partners and employees of what they rightly had coming. Such behavior, on the part of the government, "shocks the conscience," said Judge Kaplan, who is not known as a civil libertarian. A prosecutor, he wrote, quoting a Supreme Court decision, "is the representative not of an ordinary party to a controversy, but of a sovereignty whose obligation is to govern impartially; and whose interest, therefore, in a criminal prosecution is not that it shall win but that justice shall be done."

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Aftermath

Following its setback in Judge Kaplan's courtroom, the Justice Department issued prosecutors new guidance through "the McNulty Memorandum," named for a new deputy attorney general. According to a departmental press release, "[T]he new memorandum . . . instructs prosecutors that they cannot consider a corporation's advancement of attorneys' fees to employees when making a charging decision." In addition, a *Wall Street Journal* story reports that "bills proposed in the House and Senate are seeking to rewrite sections of the McNulty memo to further restrict prosecutors" (July 18, 2007).

Truly, the KPMG case is the Justice Department's Enron and should conclude with punishment meted out to those who abused their power and then lied about what they had done. But that will not happen. Indeed, the U.S. Attorney's Office for the Southern District of New York has not even shown contrition for its actions. Quite the contrary: It is appealing Judge Kaplan's dismissal of the charges against the 13 KPMG defendants and preparing to prosecute the remaining five.