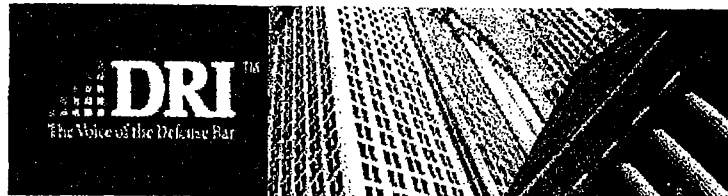

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Second Circuit Update

Thompson Memorandum's Attorneys' Fees Provision Held Unconstitutional

United States v. Stein, 2006 U.S. Dist. LEXIS 42915 (S.D.N.Y. June 26, 2006)

The Southern District of New York recently issued a harsh reproach to federal prosecutors who pressure corporations under criminal investigation to refuse to advance their indicted employees' legal fees. In what has been described as the largest tax fraud case in United States history, the Southern District held that this increasingly common government practice is unconstitutional because it violates the employees' right to a fair trial pursuant to the Fifth Amendment, as well as their Sixth Amendment right to counsel.

This prosecutorial tactic arose out of a 2003 United States Department of Justice memorandum titled "Principles of Federal Prosecution of Business Organizations," known as the Thompson Memorandum. It discusses the criteria federal prosecutors are required to consider when determining whether to indict a corporation for criminal misbehavior. One of these factors is whether the corporation has "cooperated" with the investigation. One indication that a corporation has not cooperated, according to the memorandum, is if it "appears to be protecting its culpable employees and agents . . . through the [discretionary] advancing of attorneys [sic] fees . . . ."

During the investigation into KPMG's allegedly illegal tax shelter scheme, the government pressured the accounting firm to "cooperate" by implying that KPMG's discretionary payment of legal fees "could well count against KPMG in the government's decision whether to indict the firm." KPMG succumbed to the government's coercion and, among other things, stopped advancing legal fees to 16 former firm partners once they were indicted. As a result, KPMG itself avoided indictment. The former KPMG partners then sought relief from the court.

In this case of first impression, the Southern District held the Thompson Memorandum's attorneys' fees provision unconstitutional on two grounds: it interferes with the Fifth Amendment right to a fair trial and it violates the Sixth Amendment right to counsel. The court held that the policy failed the strict scrutiny test under the Due Process Clause of the Fifth Amendment because the policy "is not narrowly tailored to achieve a compelling objective." The court reasoned that the Thompson Memorandum and the consequent pressure exerted by the government on KPMG to cut off its former partners' attorneys' fees interfered with their ability to obtain resources they otherwise would have had to defend themselves, and such an "imposition of economic punishment by prosecutors, before anyone has been found guilty of anything, is not a legitimate governmental interest – it is an abuse of power." Moreover, the court held that a company's payment of its former employees' legal fees is not "necessarily or even usually . . . indicative of an unwillingness to cooperate fully. This is especially unlikely after employees have been indicted and fired, as is the situation here."

The court held that the Thompson Memorandum and the government's implementation of it violated the former KPMG partners' Sixth Amendment right to counsel because the government's undermining of the adversary process here was not adequately justified. The court also noted that "an employer often must reimburse an employee for legal expenses when the employee is sued, or even charged with a crime, as a result of doing his or her job" and KPMG has a long history of paying for "the legal defense of its personnel, regardless of the cost and regardless of whether its personnel were charged with crimes." This was so despite the fact that KPMG's partnership agreement and by-laws are silent on the subject. In fact, one of the indicted former KPMG partners – former KPMG deputy chair and CEO Jeffrey M. Stein – had an agreement with the firm whereby he would be represented by counsel acceptable to both him and the firm, at KPMG's expense, in any suits brought against him.

Having established that it has the power to exercise ancillary jurisdiction to resolve the former KPMG partners' right to the advancement of legal fees by the firm, the court directed the clerk to open a civil docket for their claims and held that they may file a complaint within 14 days of this decision. The court also stated that such a matter would proceed in summary fashion. Although the Southern District suggested other remedies short of litigation – that the government use its influence over KPMG to cause the firm to advance the defense costs, or that KPMG do so voluntarily – neither of these avenues was taken within the 14-day period, as the former KPMG partners filed a complaint against the firm for advancement of their legal fees, *Stein v. KPMG*, S106 Civ. 5007, in early July.

If this decision stands, it will change how federal prosecutors determine whether a corporation is "cooperating" with a criminal investigation. It will free companies to make their own decision as to whether to advance legal fees to their employees without fear of reprisal by the government.

Second Circuit Breaks Ranks on Arbitration Subpoenas

Dynegy Midstream Svcs., LP v. Trammochem, 451 F.3d 89 (2d Cir. 2006)

In a split from the Eighth Circuit, the Second Circuit recently held that a district court may not enforce an arbitration subpoena served beyond the territorial limitations set forth in the Federal Rules of Civil Procedure, absent an independent basis for exercising personal jurisdiction over a nonparty.

Defendant Trammochem chartered a vessel from A.P. Moller ("A.P.") and Igloo Shipping, A/S ("Igloo") to transport cargo from Houston, Texas to Antwerp, Belgium. The charter agreement contained an arbitration clause, which required that any arbitration take place in New York City. Plaintiff Dynegy Midstream Services, LP ("DMS") was engaged to provide certain facilities and supplies to the vessel and its cargo. When the cargo arrived in Antwerp, the parties learned that it had become contaminated. It appeared that DMS's shore-flare system was the cause of the contamination.

Trammochem, A.P. and Igloo commenced arbitration proceedings in New York City. The arbitrators issued a subpoena requiring DMS, which has facilities in Houston, to produce documents related to DMS's shore-flare system at an office in Houston. DMS refused to comply. A.P. and Igloo filed a motion to compel compliance with the subpoena in the district court for the Southern District of New York. The district court ordered DMS to comply with the subpoena.

The Second Circuit reversed, holding that the district court did not have personal jurisdiction over DMS and therefore could not compel its compliance with the arbitration subpoena because Section 7 of the Federal Arbitration Act ("FAA") does not authorize nationwide service of process of an arbitration subpoena. Specifically, Section 7 of the FAA states that an arbitration subpoena "shall be served in the same manner as subpoenas to appear and testify before the court." The Second Circuit noted that when Congress intends to permit nationwide personal jurisdiction, it uses the following language regarding service: "wherever the defendant may be found" or "anywhere in the United States." The language in Section 7 of the FAA is markedly different from this language.

The Second Circuit also held that service and enforcement of an arbitration subpoena are governed by Rule 45 of the Federal Rules of Civil Procedure, which has clear geographic limitations. Specifically, Rule 45(b)(2) states that a subpoena shall be "served at any place within the district of the court by which it is issued, or at any place without the district that is within 100 miles of the place of the . . production . . . ." Rule 45(e) further provides that failure to comply with such a subpoena "may be deemed acontempt of the court from which the subpoena issued." As DMS was beyond the territorial limitations of Rule 45, the appellate court held that the district court did not have personal jurisdiction over DMS and could not compel DMS's compliance with the arbitration subpoena.

This decision is at odds with the Eighth Circuit's decision in*In re Security Life Insurance Co.*, 228 F.3d 865 (8th Cir. 2000), which held that "an order for the production of documents [does not] require[ ] compliance with Rule 45(b)(2)'s territorial limit . . . because the burden of producing documents need not increase appreciably with an increase in the distance those documents must travel." As such, the Second Circuit decision appears to suggest a need for Congress to provide guidance with respect to the enforcement of extraterritorial arbitration subpoenas.

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