

Second Circuit Rules District Court Lacked Jurisdiction to Order KPMG to Stand Trial for Its Failure to Pay Defendants' Legal Fees

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In what is said to be the largest criminal tax case in American history, the U.S. Court of Appeals for the Second Circuit in New York held on May 23, 2007 that District Judge Lewis Kaplan lacked jurisdiction to open a separate civil proceeding to resolve an attorney fee dispute between KPMG LLP and former partners and employees charged with the sale of allegedly improper tax shelters. Judge Kaplan had previously held that the government violated the defendants' Fifth and Sixth Amendment rights by pressuring KPMG to withhold the advancement of legal fees for the defendants. The Second Circuit stated that "more direct (and far less cumbersome) remedies are available," such as dismissal of the indictment. *Stein v. KPMG, LLP*, Docket No. 06-4358-cv (May 23, 2007).

In a landmark decision on June 26, 2006, Judge Kaplan strongly criticized the Department of Justice for coercing KPMG, under threat of indictment, into refusing to pay the legal expenses of former employees for their defense in the criminal tax case. *United States v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006). The government applied this pressure pursuant to guidelines set forth in the so-called Thompson Memorandum, named after then-United States Deputy Attorney General Larry D. Thompson, which listed the factors that federal prosecutors must consider when deciding whether to indict a company. One such guideline deemed a company's voluntary payment of an employee's legal fees a factor favoring prosecution of the company. As a condition of entering a deferred prosecution agreement, KPMG discontinued its longstanding practice of paying employees' legal fees "because the government held the proverbial gun to its head," thus violating the employees' Fifth and Sixth Amendment rights to a fair trial and the effective assistance of counsel. *Id.*

Reserving the option of dismissing the indictment, Judge Kaplan attempted to remedy the constitutional violations by inviting KPMG employees to sue their former employer for the advancement of legal fees in an ancillary proceeding. Judge Kaplan suggested that the constitutional violations would be rendered harmless if the defendants could successfully force KPMG to pay their legal fees. Judge Kaplan himself submitted a brief to the Second Circuit arguing that the unique circumstances that led him to take jurisdiction over the fee claims were a "perfect storm" unlikely to ever recur.

The Second Circuit disagreed and dismissed the civil dispute against KPMG for lack of jurisdiction. The court held that the remedies available to the district court did not include its "novel" exercise of

