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Developments Aplenty in the KPMG Tax Case: Partial Dismissal, and Court-Ordered Transparency In Entity/Government Negotiations

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Within recent weeks, there have been many significant developments in the long running tax shelter investigation being conducted by prosecutors in the Southern District of New York ("SDNY").

First, the District Court issued an order permitting the individual defendants in the case of *U. S. v. Stein* to obtain certain discovery arising out of i) KPMG's extensive defense submissions made to the IRS, the Department of Justice and the U. S. Senate in connection with the pertinent tax shelter transactions, and ii) the accounting firm's eventual negotiation and acceptance of a Deferred Prosecution Agreement ("DPA").

Days later, the Second Circuit ruled that the District Court could not exercise ancillary jurisdiction over KPMG in the *Stein* case to remedy what Judge Lewis A. Kaplan found to be prosecutorial overreaching in connection with KPMG's refusal to pay legal fees for its former partners and employees.

Third, on the same day as the appellate ruling, the SDNY declined criminal prosecution of the law firm of Sidley Austin LLP but extracted a payment of $39.4 million, representing Sidley's "allocable share" of certain civil tax shelter promoter penalties.

Then, on July 16, 2007, Judge Kaplan dismissed the indictment against 13 of the 16 defendants, finding that the government had engaged in unconstitutional prosecutorial misconduct arising out of the application of the Thompson Memorandum as regarding KPMG's decision not to pay these individuals' legal fees during the investigation and eventual trial. In doing so, Judge Kaplan – with the government urging him on by conceding that dismissal was an appropriate remedy for most of those individuals – has set up a potential landmark decision that should come from the Second Circuit in coming months. Meanwhile, the trial of the three remaining indicted defendants in the case will begin this fall.

And finally, other "shoes" are expected to drop involving banks, law firms and other entities that have yet to resolve issues over their involvement in the tax shelter activity.

The *Stein* case continues to feature a remarkable array of legal and tactical issues, and these developments are all of great interest. Most white collar practitioners have followed closely Judge Kaplan's opinions on the Thompson Memo/legal fee issue. The Court's preliminary opinions in part prompted a new McNulty Memorandum on the prosecution of business entities, Congress is considering legislation on related privilege waiver issues, and the case is covered not just in the legal trades but on the news and editorial pages of major newspapers. The action against Sidley follows the government's disposition of a related matter against another law firm, Jenkens & Gilchrist, which has ceased operations as a result of its participation in tax shelter activity. Sidley, which acquired Brown & Wood, the firm at which R. J. Ruble had engaged in much of the conduct alleged against him in the *Stein* indictment, resolved its matter with an

apology, payment of a civil penalty, and, compared to KPMG's specific and detailed factual admissions, a more general acknowledgement of institutional wrongdoing.

However, with all the attention given to the legal fee dispute, the first noted development – open discovery of the negotiations between the prosecutors and KPMG -- has largely escaped attention. Yet this ruling also has potentially sweeping implications for white collar practitioners who represent business entities or individuals in connection with any kind of corporate criminal matter. At bottom, the Court's decision would open to disclosure documents, emails, and other material that would embody the entire course of an entity's negotiations toward a declination, a deferred or non- prosecution agreement, or even, possibly, a guilty plea. Individuals affiliated with the entity who are charged in a related criminal indictment may then be able to obtain all such material.

In the discovery order filed on May 1, 2007, Judge Kaplan granted, to a large extent, a Rule 16 motion filed by the *Stein* defendants, and denied to the same extent a related motion by KPMG to quash a Rule 17(c) subpoena served upon the firm. The Court directed the SDNY prosecutors to produce i) correspondence between KPMG and either the IRS, the Senate, or the Justice Department regarding the pertinent tax shelter products, ii) material portions of a "white paper" submitted by KPMG to the government in an effort to avoid indictment, iii) any drafts of the Statement of Facts issued by KPMG at the time it entered into the DPA, and iv) all internal memos prepared by KPMG *or its counsel* that either summarize their communications with government officials or discuss matters relating to the facts alleged in the sweeping *Stein* indictment. In evaluating each separate category, the Court found that the material met the standard of Rule 16, *i.e.*, assisting the defendants in "uncovering admissible evidence, aiding witness preparation, corroborating testimony, or assisting impeachment of rebuttal." (*United States v. Lloyd,* 992 F.2d 348, 351 (D.C.Cir. 1993).

Most of the documents in the above categories, obviously, were in the possession of KPMG and not, apparently, the SDNY. But as a preliminary finding of note to anyone involved in corporate criminal investigations, the Court found that the documents in the physical possession of KPMG were in the "possession, custody and control" of the government by virtue of the government's unqualified right, under the KPMG DPA, to request any documents from the firm in connection with the tax shelter investigation. And while the DPA permitted a carve out for documents considered privileged, the Court also found that KPMG had failed to establish any privilege or work product protection for this material, opening up all documents in the above categories to discovery.

The ruling had an immediate impact in the case. The government's papers in connection with the motion to dismiss attached various exhibits that embodied some of the delicate and highly charged negotiations that led to the DPA. Among other documents, the government filed a redlined version of KPMG's draft acknowledgement of wrongdoing, showing those specific statements over which the prosecutors and KPMG's counsel were arguing. It also submitted a copy of an obviously sensitive email from KPMG's outside counsel to its in-house counsel describing and commenting on the status of the negotiations with the government. And to drive home the point, in his decision dismissing the indictment, Judge Kaplan relied in part on emails and other materials in the record that also appeared to have been produced in response to his discovery order.

At bottom, if Judge Kaplan's views are adopted in subsequent decisions, both in-house and outside counsel for business entities and their opposite investigators and prosecutors must be aware that much of the written material generated on the defense side, and even some on the government side, may be discoverable under Rule 16, including material that at least facially might appear to be privileged or attorney work product.

Whether such material is admissible during a criminal trial is almost irrelevant. The key point is that documents such as attorney submissions regarding factual matters, drafts of factual statements, and even internal attorney or client memoranda regarding such matters may all see the light of day, one way or the other. A company's former officers, directors or employees who are charged with related crimes could review essentially the entire relevant course of events underlying the eventual disposition of the matter involving their former company. Litigants in subsequent civil cases would also find an easier path to nearly all such documents. On the other hand, one wonders if a court would take the same view of the "custody and control" issues

beyond the formal termination of any deferred prosecution agreement, or in the context of DPAs or non-prosecution agreements containing more general cooperation language. The implications of the discovery ruling for white collar practitioners are, in short, uncertain, but potentially sweeping and profound.

Beyond the world of corporate criminal investigations, though, the Judge's ruling on custody and control might have a broader impact. Where information relevant to any motion or other issue might be present, an indicted defendant might consider seeking to obtain information held by *any* party, whether entity or individual, who is subject to an "unqualified right" in a routine plea agreement to produce material or information to the government. If such information is relevant to a pending issue, whether a motion or on the merits, Judge Kaplan's discovery order might pave the way for disclosure. And in yet another way, then, *Stein* could alter criminal practice.

The ruling should at least suffice as fair warning to white collar practitioners, and we will all await further developments on this issue and the case as a whole.