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# WILL THE GOVERNMENT PUNISH YOU FOR STANDING BY YOUR EMPLOYEES?

## ADVANCEMENT OF LEGAL FEES UNDER THE McNULTY MEMORANDUM

**by R. Christopher Cook**

Every time a corporation becomes the target of scrutiny by law enforcement, individuals within that organization inevitably come under pressure. Inasmuch as a corporation can act only through its employees and agents, any challenge to the corporation's acts also constitutes a challenge to those individuals' acts. Leaving aside the personal stress and trauma that come from being the target of a government investigation, these individuals can accrue legal bills that are beyond the ability of any but the richest to pay personally. Accordingly, the corporation's general counsel and compliance officer quickly find themselves asking whether the corporation can pay those legal fees and otherwise support the company's employees consistent with the organization's desire to remain cooperative in the eyes of government investigators.

The recently revised "Principles of Federal Prosecution of Business Organizations" issued by Deputy Attorney General Paul J. McNulty on December 12, 2006 (popularly, the "McNulty Memorandum") assures corporations and other business organizations that they will *not* be penalized for advancing attorneys' fees to employees and agents who are under investigation or indictment. By contrast, other types of support provided to employees, such as continued employment or information sharing under a joint defense agreement, may still be viewed as inconsistent with

This article originally appeared in the February 2007 issue of *Compliance Today*. Requests for reprints of that issue can be directed to the Health Care Compliance Association at 888/580-8373.

corporate cooperation under the McNulty Memorandum. Corporations must assume that they may be penalized if they enter into a joint defense agreement with an employee whom the Department of Justice ("DOJ") views as "culpable." The same is true if the corporation fails to terminate or otherwise sanction such an employee.

The McNulty Memorandum represents a shift, in some respects, from policies articulated in 1999 and 2003 by the DOJ. How we have come to this point and how these changing policies affect corporate behavior present a fascinating story.

## THE FEDERAL GOVERNMENT'S WAR ON CORPORATE FRAUD

Historically, the advancement of legal fees and the provision of other support to accused employees was not an issue. Indeed, the legal and business community largely assumed that employees charged with misconduct in the course of their employment would have their legal costs paid and would receive other reasonable support from their employer. Often, these employees would continue to receive a paycheck while they fought the charges against them. Only after a guilty plea or conviction would the employee be terminated.

In recent years, the DOJ has become increasingly aggressive in pursuing perceived corporate fraud. The DOJ's fight against corporate fraud was precipitated by the spectacular collapse of business organizations such as Enron, WorldCom, and Global Crossing. The government established a Corporate Fraud Task Force pursuant to an executive order on July 9, 2002. This task force spearheaded an unprecedented effort to root out and punish corporate fraud. As a direct result of this initiative, many corporations changed their approach to supporting employees who had been accused, but not convicted, of wrongdoing.

The government's campaign against corporate fraud resulted in three phenomena pertinent to this discussion. First, prosecutors pressured corporations to waive the attorney-client privilege and provide to the DOJ the work product of the company's lawyers. This gave the government access to the results of internal investigations, as well as the legal advice that corporate counsel gave to management regarding actions now being characterized as criminal. Second, prosecutors and regulators fostered the assumption that corporations would self-report alleged noncompliance with laws discovered within the corporation. Business organizations were expected to self-disclose and "cooperate" or face the fate of Arthur Andersen LLP.[1] Third, the government began to pressure corporations to refuse support to employees viewed by the government as "culpable." It is this last development that we are considering here.

The government's policy regarding corporate cooperation was codified in a January 2003 memorandum from then-Deputy Attorney General Larry Thompson. This memorandum was the predecessor to the McNulty Memorandum and, as might be expected, was generally known as the "Thompson Memorandum." The memorandum set forth nine factors that federal prosecutors were required to take into account in deciding whether to bring charges against a business organization. Previously, such decisions were made pursuant to a nonbinding policy set forth by a prior Deputy Attorney General, Eric Holder, in 1999. Unlike the Thompson Memorandum, however, the Holder Memorandum was not binding on prosecutors, but merely recommended the factors to be considered when charging a business organization.

The portion of the Thompson Memorandum relevant to this discussion is quite short, comprising only two sentences. Specifically, the Thompson Memorandum stated:

> Another 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, either through the advancing of attorney's fees, through retaining the employees without sanction for their misconduct, or through providing information to the employees about the government's investigation pursuant to

1 It did not escape notice to corporate America that Andersen was convicted and put out of business *even though* that conviction was later reversed on appeal. The message was clear: Cooperate or risk corporate extinction regardless of actual guilt.

a joint defense agreement, may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation.

In a footnote, the Thompson Memorandum softened this policy slightly by noting that the government would not consider it a "failure to cooperate" if a corporation complied with state law *requiring* the corporation to pay legal fees prior to a formal determination of guilt. These provisions also appeared in the nonbinding Holder Memorandum.

In the years following the issuance of the Thompson Memorandum, many prosecutors embraced with gusto the policy of demanding corporate cooperation. These prosecutors openly insisted that corporate targets cut off support for employees whom the government viewed as "culpable."

The effect on the behavior of business organizations was immediate. Even in the absence of a demand by prosecutors, many corporations were not willing to take the risk that the government would view them as noncooperative. Companies often fired employees who became the subject of government scrutiny. Likewise, a shrinking number of corporations advanced legal fees to accused employees or shared information pursuant to joint defense agreements.

This new dynamic clearly benefited prosecutors, giving them the power to demand that employees submit to interviews, accept guilty pleas, or otherwise do the government's bidding upon pain of being left to defend a criminal investigation without the financial or logistical support of their (often former) employers. Whether this new power shift in favor of prosecutors resulted in more just outcomes became a question for vigorous debate within the criminal law community. Prosecutors could point to convictions and lengthy prison terms for executives as evidence that justice was being done. Defense lawyers, by contrast, could enumerate constitutional rights given up by individuals on pain of personal financial ruin as evidence that these individuals were being improperly pressured by the government. That is where the matter stood until late 2006.

## INDEMNIFICATION AND ADVANCEMENT OF FEES

Before considering further how the government's campaign to stamp out corporate fraud has changed in very recent months, it is worth pausing to consider the law relating to the payment of employees' legal fees. Notwithstanding the government's antagonism to such support for accused employees, payment of legal expenses was well established in the law long before the Holder and Thompson Memoranda were published. Payment of legal costs constitutes a legitimate means by which a corporation can assist employees who must defend against accusations of wrongdoing in how they performed their jobs.

Payment of legal fees for employees and other agents involves two interrelated issues. The first question is whether the individual is *entitled* to be indemnified for expenses incurred in defending against accusations of wrongdoing. Only if the individual is entitled to indemnification must a business organization decide whether it *may* or *must* advance those legal fees before the individual's guilt or innocence is determined.

If an employee, officer, or director successfully defends against an investigation, lawsuit, or criminal charge, he is almost always entitled to be indemnified for attorneys' fees and expenses. Section 145(c) of the Delaware Corporation Code is a good example, mandating the indemnification of attorneys' fees and expenses when "a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding." 8 Del. C. § 145(c). This is consistent with the common law, which has long provided for the indemnification of agents for expenses incurred in connection with the agency relationship. The policy behind this rule is self-apparent; agents who incur costs while acting legally and in good faith should expect to have the principal cover their expenses.

Indemnification is available only after the fact — that is, after the employee or other agent has incurred the expenses and has prevailed in the underlying action. Because the cost of defending a typical criminal investigation can be enormous, most individuals cannot wait to seek repayment, but are compelled by practical circumstances to request the advancement of expenses from the organization. Accordingly, the critical issue often is whether a corporation must or may advance fees and expenses.

If the law requires a corporation to advance fees and expenses, the corporation obviously must comply; even the Thompson and Holder Memoranda recognized as much. Such a legal obligation can arise from a number of sources. Some state statutes grant employees or other agents the right to seek or demand advancement. In New York, for example, employees can petition a court to order advancement not prohibited by the company's bylaws. See New York Business Corporation Law § 725(b)(2). In many states, such as Delaware, a corporation can bind itself through its bylaws to advance fees and expenses. Additionally, a corporation can bind itself via contract to advance fees and expenses.

Courts in most states have been quite firm in ordering the advancement of fees and expenses where it is required. This is particularly true when a corporation voluntarily takes on the obligation to advance fees and expenses in its bylaws. Courts generally order such advancement even when the requestor has acted unlawfully or criminally, provided the bylaws contain no exception for such circumstances. Delaware courts are among the most unyielding in this regard, even ordering "fees for fees" when corporations balk at honoring their bylaws' promises to advance fees and expenses. That is, if a Delaware corporation refuses to advance fees to its employee, officer, or director in contravention of its own bylaws and forces the requestor to bring a lawsuit to enforce the bylaws, Delaware courts will order the corporation to pay for the requestor's legal expenses in bringing that lawsuit.

Where a corporation is not *obligated* by law to advance fees and expenses, the corporation nevertheless may *elect* to do so. Here again the corporation's bylaws typically govern the terms on which the decision to advance fees must be made. Similarly, if the indemnification and advancement rights arise from a contract rather than the company's bylaws, the terms of that contract will control.

Whether advancement is mandatory or voluntary, it typically is accompanied by an undertaking by the requestor to repay the money if he ultimately does not prevail on the underlying legal dispute. Most corporation codes and bylaws explicitly require such an undertaking, and further require that the requestor certify that he acted lawfully and in the best interests of the corporation. *See* Del. C. § 145(e).

The most difficult decision that a corporation must make in this regard is whether to grant a request for voluntary advancement of fees and expenses when the law or the corporation's bylaws do not require it. The corporation can benefit from ensuring that its employees, officers, and directors are represented by capable and ethical counsel. After all, the corporation's interests can be severely compromised if an employee unwisely hurts his own case. Under the doctrine of *respondeat superior,* the corporation is responsible for the actions of its agents; a conviction of an employee can be the end of the line for the company.

At the same time, however, a corporation may be wary of paying the expenses of an employee who has broken the law. Conferring such a benefit on an employee who has risked the company's well-being may be galling to management. More to the point, outside constituents, including shareholders and the government, may frown on a corporation that seeks to protect an employee who clearly has acted illegally. As we have seen, the Thompson Memorandum codified precisely such a bias against assisting a potentially "culpable" employee.

## JOINT DEFENSE AGREEMENTS AND INFORMATION SHARING

Another common means by which business organizations historically have provided support to accused employees is to enter into a "joint defense agreement" (also known as a "common interest agreement") under which the corporation can share information regarding the government investigation with counsel for individuals. This can be a critical means of leveling the playing field for individual targets of a corporate criminal investigation, whose counsel otherwise are at a disadvantage when dealing with prosecutors. Unlike defense counsel, the prosecutors typically have comprehensive, reliable information regarding the status of the investigation and the facts known to the business organization. Notwithstanding the government's antagonism to such arrangements, the law clearly permits such information sharing among counsel for the corporation and its accused employees.

The purpose behind a joint defense agreement is to avoid waiver of the attorney-client privilege and the work product doctrine. When conducted by legal counsel, an organization's response to alleged wrongdoing presumptively is protected by the attorney-client privilege and the work product doctrine. This is true even in the absence of an active government investigation, but it is especially true when the government is scrutinizing the company's actions. Thus, an organization reasonably can expect that internal legal strategy decisions will remain confidential and the communication between its attorneys and its employees will not be subject to subpoena, provided the company does not waive the privilege. This protection is not, however, absolute. Serious negative consequences can flow from blithely assuming that these privileges protect — and will continue to protect — all aspects of an organization's investigation or legal defense.

Just as privileged communications must be kept confidential, an organization facing investigation also must consider how to communicate with other similarly-situated subjects of the investigation, including individual employees. The "joint defense" or "common interest" privilege is a doctrine developed by courts to permit codefendants and others facing similar legal exposure to cooperate and share otherwise privileged information without waiving those privileges. Virtually all courts recognize some sort of common interest privilege, though some courts have stated that the agreement between the parties should be in writing. *See, e.g., United States v. Almeida,* 341 F.3d 1318, 1326 n.21 (11th Cir. 2003).

Joint defense agreements can play an important role in an organization's response to a government investigation. At the same time, and for the same reasons, the government typically views such an agreement as an impediment to its investigation. First, a joint defense agreement can limit the ability of the organization to cooperate with the government. For example, if a corporation enters into a joint defense agreement with its employees, interviews conducted pursuant to the joint defense agreement may be subject to privileges held by both the company and the employee. This would restrict the company's ability to waive the privilege if that is requested in a cooperation agreement with the government. In addition, some prosecutors oppose joint defense agreements on the belief that any advantage given to the target — in this case, accurate information — hinders the government's ability to obtain a conviction. To the extent that these prosecutors equate obtaining a conviction with doing justice, they likewise view joint defense agreements as obstructing that goal.

## JUDICIAL AND LEGISLATIVE CHALLENGES TO THE THOMPSON MEMORANDUM

The government's policy of pressuring corporations to refuse to support allegedly "culpable" employees came to a head on June 26, 2006 when federal judge Lewis Kaplan in New York held that the government's actions violated the guarantees of Due Process and the right to counsel embodied in the Fifth and Sixth Amendments to the United States Constitution. Judge Kaplan's lengthy opinion is worth reading, as it lays out in detail the government policies and practices that led the court to conclude that the Thompson Memorandum and the manner of its application in that case were not consistent with the Constitution. *See United States v. Stein,* 435 F. Supp. 2d 330 (S.D.N.Y. 2006). In short Judge Kaplan concluded that the government's "zeal" to prosecute crimes clouded its judgment and caused it to "violate[ ] the Constitution it is sworn to defend." *Id*. at 336.

The *Stein* decision arose out of the prosecution of 19 individuals for marketing allegedly unlawful tax shelters through the accounting firm KPMG. Historically, KPMG had paid for the legal defense of any personnel accused of wrongdoing. In this case, however, KPMG refused. Judge Kaplan, after hearing evidence from KPMG's General Counsel and others, concluded that the accounting firm refused to pay "because the government held the proverbial gun to its head." *Id*. Specifically, Judge Kaplan concluded that KPMG cut off financial support and refused to advance defense costs to the individual defendants because prosecutors threatened to retaliate against KPMG for doing so. Judge Kaplan concluded that this conduct by the government, including the policy as set forth in the Thompson Memorandum, was unconstitutional.

Some months later, the Senate Judiciary Committee likewise took aim at the Thompson Memorandum. The Committee held hearings in the fall of 2006 at which it heard testimony regarding the application of the policies set forth in the Thompson Memorandum. Much of the attention given to this testimony related to the DOJ policy of demanding waiver of the attorney-client privilege. The Committee also heard about the DOJ conduct described in the *Stein* decision — pressuring target companies to cut off their employees. After hearing this testimony, the chair of the Committee, Pennsylvania Senator Arlen Specter, introduced the "Attorney-Client Privilege Protection Act of 2006" to prohibit the DOJ from demanding waivers of the attorney-client privilege as a condition of avoiding charges. That same legislation prohibited the DOJ from conditioning any civil or criminal charging decision on a corporation's decision to provide counsel to employees, pay for legal expenses, enter into a joint defense agreement, or fail to terminate an employee for exercising his constitutional rights. Five days after the legislation was introduced, on December 12, 2006, the DOJ backed away from many of the Thompson Memorandum's policies by issuing the McNulty Memorandum.[2]

## THE DECEMBER 2006 McNULTY MEMORANDUM

The McNulty Memorandum, like the Thompson Memorandum, constitutes a binding policy on United States Attorneys and DOJ department heads responsible for criminal prosecutions. It changes dramatically in some respects the government approach to corporate "cooperation" in deciding whether to bring criminal charges. In other respects, however, it does not change government policy at all.

Most of the media attention relating to the McNulty Memorandum has focused on its pronouncements regarding waiver of the attorney-client privilege. Although not discussed in this article, those provisions of the McNulty Memorandum impose written approval requirements on prosecutors seeking a privilege waiver and prohibit prosecutors from penalizing corporations for refusing to accede to such requests in some circumstances. Many commentators have questioned whether these procedural changes will lead to substantive shifts in government practice.

The McNulty Memorandum goes further in changing government policy regarding the advancement of legal fees. The new policy flatly prohibits prosecutors from considering a corporation's advancement of legal fees in evaluating the quality of a corporation's cooperation. The only exception is "extremely rare circumstances" where the payment of legal fees is part of an effort by the corporation to impede the government's investigation. In this regard, therefore, the McNulty Memorandum appears to have taken to heart Judge Kaplan's criticisms and extricated the DOJ from a corporation's decision to advance legal fees to its employees.

The most notable aspect of the McNulty Memorandum's new policy regarding the advancement of legal fees is the lack of any distinction between corporations that are obligated to advance such fees and those that have the discretion to do so. The Memorandum itself notes that "[m]any state indemnification statutes grant corporations *the power* to advance the legal fees of officers under investigation prior to a formal determination of guilt." McNulty Memorandum at 3 (emphasis added). The Memorandum further notes that, consistent with this power, "many corporations enter into contractual

2 Although Senator Specter's proposed legislation was not enacted in the 109th Congress, both Senator Specter and his successor, Senator Patrick Leahy of Vermont, have promised to reintroduce the legislation in the 110th Congress if they deem it necessary in light of changes in government policy and practice.

obligations to advance attorneys' fees through provisions contained in their corporate charters, by-laws or employment agreements." *Id*. Notwithstanding the fact that this contractual obligation to advance legal fees is a duty voluntarily accepted by the corporation, the McNulty Memorandum unequivocally states that "[a] corporation's compliance with governing state law and its contractual obligations cannot be considered a failure to cooperate." Thus, the McNulty Memorandum applies the same standard to companies that *choose* to advance legal fees as it does to those that *must* do so. [3]

Notwithstanding the DOJ's dramatic change of position regarding the advancement of legal fees, the government did not in any way change its policy regarding other support that a business organization could provide to employees. Accordingly, the DOJ still will consider "whether the corporation appears to be protecting its culpable employees and agents" in deciding whether to bring criminal charges. The McNulty Memorandum specifically sets forth as examples of "a corporation's promise of support to culpable employees and agents" the retention of employees "without sanctions for their misconduct" and the provision of "information to the employees about the government's investigation pursuant to a joint defense agreement." *Id*. Accordingly, it seems that a corporation still may be penalized for refusing to fire an employee the government considers to be "culpable." The DOJ also may still punish a business organization for entering a joint defense agreement, regardless of whether that information sharing actually obstructs the government's investigation.

Finally, the McNulty Memorandum continues to assume that the DOJ legitimately can decide which employees are "culpable" prior to a determination of guilt. Although this prejudgment of an employee's culpability has been removed from the process of advancing legal expenses, the DOJ continues to demand that purportedly "culpable" employees be fired and denied access to information regarding the government's investigation long before actual guilt or innocence has been decided at trial.

## CONCLUSION

Under the McNulty Memorandum corporations can safely enact bylaws provisions and enter into contractual obligations to advance legal fees to their employees and agents should they in the future become subject to criminal investigation. The government has stated without reservation that such corporate action will not be considered to be "uncooperative" in the event that the corporation later is obligated to pay the legal fees of individuals whom the government considers to be "culpable." Corporations and other business organizations still must be careful, however, when entering into joint defense agreements or other information-sharing arrangements with employees who are the subject of a government investigation. Moreover, corporations must consider carefully whether to continue the employment of such "culpable" employees even before their guilt has been determined at trial. The government has made clear that these aspects of the Thompson Memorandum remain valid, effectively demanding that corporations continue to pre-judge their employees' guilt in these regards. Whether the courts or Congress will challenge these policies remains to be seen. If, however, Senator Specter's legislation is re-introduced and passed, we can expect to see these tactics revisited also.

## LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

**R. Christopher Cook**
1.202.879.3734
christophercook@jonesday.com

3 The McNulty Memorandum remains silent regarding the timing of a corporation's decision to contractually obligate itself to pay legal fees. Many companies, of course, agree to advance legal fees only after discovering the pendency of the government investigation; that is, the company does not obligate itself to make such payments in its bylaws or an employment agreement. That was the situation with KPMG in the *Stein* case. The language of the McNulty Memorandum at least suggests that these contractual obligations would not be interpreted as a failure to cooperate. An aggressive prosecutor might, nevertheless, argue that the contractual obligations permitted under the McNulty Memorandum are limited to those that pre-date the initiation of a criminal investigation and do not include after-the-fact decisions to support an employee by paying for his legal expenses. Such an interpretation would be inconsistent with Judge Kaplan's opinion in *Stein*.

The views set forth herein are the personal views of the author and do not necessarily reflect those of the Firm.