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Practice

Another Troublesome Indictment

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With the advent of DNA evidence, it is becoming almost a common event to hear of the exoneration of yet another individual who was wrongfully convicted. These stories routinely include a recitation of the evidence that was offered at the trial that resulted in an erroneous finding of guilt. We have come to learn, through these experiences, that some types of evidence, long viewed as inherently reliable, is in reality quite fallible. A good example of evidence that has been greatly undermined by DNA testing is eye-witness testimony. Perception, memory and reporting, by even the best-intended witness, can be influenced and undermined by a variety of factors and does not consistently stand up to scientific testing.

Maybe more surprising, there is also emerging a pattern of cases in which DNA testing is proving the innocence of defendants who gave statements confessing to the crimes for which they are later exonerated. Difficult as it may be to come to learn that what we think that we see and remember may not prove to be true, it is perhaps even harder to understand how a person may admit to a crime that he or she did not commit. It may, upon analysis, be understandable that the testimony of bystanders or victims who find themselves drawn into criminal events may prove to have been unduly influenced, even if unintentionally, by subsequent prompting or suggestions made by law enforcement during the investigation that follows, or may have been shaky from the beginning as a result of the surprise or trauma of having witnessed or been victimized by the crime. The statements or testimony of someone who participated in the events would seem, by contrast, a better basis on which to ground a conviction. After all, what would make someone admit to wrongdoing that he or she did not in fact commit?

The answer may come from the considerable power of those conducting criminal investigations, weighed against the shrinking options of businesses and individuals who find themselves in the cross-hairs of those investigations. The two high-profile indictments in tax shelter cases offer examples of reasons to be concerned.

Lingering Concerns with the KPMG Investigation

The initial indictment in *United States v. Stein*,[1] commonly known as the KPMG indictment, was issued in August 2005. Superceded once, the case has yet to come to trial, and there is justifiable uncertainty about when the trial may start and what the case may look like when it does. At issue are the actions of former KPMG partners and others in connection with the promotion and implementation of allegedly abusive tax shelters.

As has been widely reported, in June 2006, the district judge in *Stein* held that the government had interfered with the constitutional rights of the defendants through policies and actions that, the judge concluded, caused KPMG to refuse to pay the legal fees for its partners or former partners who either refused to waive their fifth amendment rights and cooperate with the government, or who were indicted.[2] The court in *Stein* directed that an ancillary proceeding by the former KPMG partners against KPMG be opened to address the issue of whether KPMG should be directed to pay their legal fees. In May 2007, the Second Circuit held in *Stein v. KPMG* that the ancillary proceeding was not the proper remedy for the constitutional violations identified by the lower court, and dismissed the complaint against KPMG.[3]

Ensuring further proceedings, the Second Circuit expressly did not determine the issue of whether constitutional violations had occurred, but stated that, "[d]ismissal of an indictment for Fifth and Sixth Amendment violations is always an available remedy."[4] On remand, the government took the position dismissal is the only appropriate remedy for the constitutional violations found by the judge, while noting repeatedly that the government continues to disagree with the court's findings concerning those violations. On July 16, 2007, the district court granted the motion to dismiss the indictment against 13 of the defendants, and the government promptly appealed to challenge the court's original findings.

At the heart of the controversy in *Stein* are the policies that were embodied in the so-called Thompson memorandum, and the actions of the prosecutors in conducting the investigation pursuant to those policies. In the most recent decision, the district judge in *Stein* held that the conduct of the prosecutors violated the substantive due process rights of the defendants: "Their deliberate interference with the defendants' rights was outrageous and shocking in the constitutional sense because it was fundamentally at odds with two of our most basic constitutional values—the right to counsel and the right to fair criminal proceedings."[5]

Formally titled "Principles of Federal Prosecution of Business Organizations," the Department of Justice memorandum set out nine factors that prosecutors were to consider in determining whether to charge a business entity with a crime. As the district judge described the history of the investigation in the opinion in *United States v. Stein*, however, two factors had an overwhelming influence on the course of the investigation—the entity's cooperation with the government, and the remedial actions taken by the entity. The Thompson Memorandum set out as a "general principle" that prosecutors "may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive the attorney-client and work product protection" and "may also consider other remedial actions, such as … disciplining wrongdoers."[6] The Thompson Memorandum went further, advising that prosecutors should look for factors that the government views as showing "a corporation's promise of support to culpable employees and agents, either through advancing attorneys fees, through retaining the employees without sanction for their misconduct, or through providing information to the employees about the government's investigation pursuant to a joint defense agreement."

The consequence of these policies, in both the KPMG investigation and in general, was that witnesses were faced with possible unemployment and the termination of legal fees if they were deemed not to be cooperating with the government. The district judge in *Stein* found that these policies worked to coerce the defendants to give up their Fifth Amendment right against self-incrimination, and jeopardized their Sixth Amendment right to counsel.[7] In the most recent decision, the court in Stein focused on the

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actions of the government in pressing KPMG to condition continued employment on cooperation with the prosecutors, stating that such acts "demonstrate a willingness by the prosecutors to use their life and death power over KPMG to coerce its personnel to bend to the government's wishes notwithstanding the fact that the Constitution barred the government from doing directly what it forced KPMG to do for it."[8]

In addition to risking that individuals caught in a criminal investigation may be coerced to waive their Constitutional rights, the government's polices and practices also risk that witnesses may be pressured to tailor their testimony to meet the government's theories, or face the consequences of being deemed "noncooperative." Under the provisions of the Thompson Memorandum, the determination of which company personnel deserve to be disciplined or discharged was not made by an employer in a business context, but by an entity whose continued existence was threatened if it did not resolve these issues in a manner that satisfied the government. The risk was great that, rather than face a destructive prosecution, the positions presented by an entity or its personnel may have lined up more closely with the government's theory than with the objective truth.

The criticisms of the Thompson Memorandum led to a change in the government's stated policies, set out in December 2006 in the so-called McNulty Memorandum. The revisions have done nothing to quell the possibility that witnesses will be motivated to bring their testimony in accord with the government's view so as to be deemed cooperative.[9] The most vaunted change from the Thomson Memorandum to the McNulty Memorandum concerned the language regarding waiver of the attorney-client privilege. Limitations were placed on when prosecutors may seek a waiver, and set in place certain procedural requirements.[10] Whether an entity "appears to be protecting its culpable employees and agents," including through continued employment, remains a factor to be considered in determining whether to bring criminal charges against the entity. Prosecutors are now told that they "generally should not take into account whether a corporation is advancing attorneys' fees to employees or agents under investigation or indictment," but they may still make inquiries about the practice.[11] At bottom, it is left to the prosecutors to determine the worth of any cooperation, which will always bring with it the risk of whether the prosecutor is willing to entertain that the proffered facts may not fit the government's theory.

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New Concerns with the EY Indictment

On May 30, 2007, the U.S. Attorney's Office for the Southern District of New York announced the indictment of four current and former partners of the Ernst & Young accounting firm. Formally captioned *United States v. Coplan*,[12] the EY indictment issued in the midst of the on-going controversy over the KPMG indictment.

The indictment in *Coplan* charges that the defendants and others "participated in a scheme to defraud the IRS by designing, marketing, implementing and defending tax shelters using means and methods intended to deceive the IRS about the bona fides of those shelters, and about the circumstances under which the shelters were marketed and sold to clients."[13] The indictment then goes on for many pages to enumerate the "means and methods" that are alleged to have been intended to deceive the IRS. Without question, there are allegations in the EY indictment that, if proven as charged, constitute serious criminal acts.

There are charges in the indictment, however, that would appear to be more a matter of differing opinions than criminal wrongdoing. In other words, if the defendants believed the positions that they were taking at the time, the IRS's subsequent disagreement with those positions should not give rise to a finding of criminality.

Fundamental to criminal tax charges is the element of willfulness. As the Supreme Court has repeatedly held, the willfulness element of criminal tax offenses requires "the Government to prove that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty."[14] An individual who, in good faith, misunderstands the tax laws or reaches an incorrect conclusion about their application is not guilty of a federal tax crime, regardless of whether the position taken by the taxpayer is objectively reasonable. Thus the Court in *Cheek v. United States* concluded: "In the end, the issue is whether, based on all the evidence, the Government has proved that the defendant was aware of the duty at issue, which cannot be true if the jury credits a good-faith misunderstanding and belief submission, whether or not the claimed belief or misunderstanding is objectively reasonable."[15]

The EY indictment describes four transactions, depicted as tax shelters, that the defendants allegedly designed, promoted, and implemented. A number

of the allegations in the EY indictment charge, in essence, that the defendants claimed that the transactions met one or more business purposes, which the prosecution contends were not valid. For example, the EY indictment alleges that the defendants "created, assisted in creating, and reviewed transactional documents and other materials containing false and fraudulent descriptions of the clients' motivations for entering into the transactions, and for taking the various steps that would yield the tax benefits"[16] The indictment depicts nontax purposes such as the creation of investment vehicles, asset management, asset protection, estate planning, and diversification of investments as an alleged "false cover story."[17] In some instances, the indictment charges that it was criminal for the defendants to advise their clients to take steps that would serve these business purposes and thereby strengthen the tax positions taken in connection with the transactions.[18]

Many transactions have both tax and nontax purposes. The EY indictment alleges that in many instances, the defendants knowingly and intentionally disguised or misleadingly omitted the tax purposes in statements made about the transactions,[19] and if proven, the government may have a valid theory of criminality. The indictment seems to be on far weaker ground, however, in contending that assertions of some business purposes were criminally made. At issue should be whether, as required by *Cheek*, the defendants believed, in good faith, that the stated business purposes may have existed along with the tax benefits in the transactions. It would seem, therefore, especially egregious to suggest that tax professionals who advise their clients to bring their conduct in accord with a transaction that may be supported under the law should be faulted, let alone indicted, for those efforts.

The defendants are also charged with making false statements to the IRS by, among other statements, reiterating the positions concerning the business purposes of the transactions at issue.[20] The indictment also charges defendants with acts resulting in false statements in connection with IRS examinations of EY clients.[21] By these allegations, the government is in effect charging the defendants with advocacy positions taken in representation of their clients. Taxpayers have a right to disagree with the government's positions regarding the tax treatment of a transaction. The taxpayers in these cases may well have believed that the transactions served the business purposes that were described to them. Indeed, it is well within the realm of possibility that some of the business purposes presented for various aspects of the transactions did indeed meet the needs of some of the taxpayers who engaged in the transactions.

The problem, of course, is that the government has decided not to believe any of these positions. The failure of the government to accept the position of a taxpayer or a taxpayer's representative should not, however, result in criminal charges. There is simply too great a risk that such a threat will chill the ability of taxpayers and their advocates to bring fairly raised, even if ultimately unsuccessful, facts and theories to the fore.

Finally, in one example, the indictment depicts as a wrongful act a statement by one defendant, in response to an inquiry as to how to handle an IDR, "'Never give them more than they ask for. (That's why we never allow clients to attend examinations, they talk too much).'"[22] It is most difficult to see where the crime is in this allegation. There is no obligation to present the IRS with "more than they ask for." Taxpayers have every right and reason to have their positions presented by their representatives rather than speaking directly with government agents, who may well misinterpret the statements made by nontax professionals. The advice set out in the language quoted in the indictment, while perhaps blunt, is arguably well taken.

The EY indictment gives rise to a corollary concern to that raised by the KPMG investigation. Throughout the KPMG investigation, and other investigations of this era, there is heightened motivation for witnesses, however well-intended, to align their description of events with the prosecution's theories, and thereby to be viewed as cooperative. Now with the EY indictment, there is the risk that positions taken as to the tax treatment of transactions may result not only in a dispute with the IRS, but an allegation that the positions are somehow falsely taken and criminally wrong.

It is beyond dispute that civil and criminal enforcement play a vital role in our tax system. It also cannot be fairly disputed that the integrity of the tax system was severely challenged by the conduct of a small number of tax professionals in recent years. Unfortunately, the two most prominent indictments in the so-called tax shelter wars go further than necessary to remediate the problems, and create other risks to a sound system of tax administration. In so doing, the government appears to be following the ill-advised strategy of another current war, as stated by the Director of National Intelligence: "We can take the city, but we'd have to kill everyone in it."

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ENDNOTES

1 *United States v. Stein*, S1 05 Crim. 0888 (S.D.N.Y.) (LAK).

2 *United States v. Stein*, 435 F. Supp. 2d 330 (D.N.Y. 2006).

3 *Stein v. KPMG, LLP*, CA-2, 486 F3d 753 (2007).

4 *Id.*

5 *Id.*, at 38.

6 Thompson Memorandum at VI.B.

7 In a later decision, the district court granted a motion by two defendants to suppress statements made in interviews with prosecutors, finding that the defendants submitted to the interviews because KPMG threatened to terminate their employment or legal fees unless they cooperated with the investigation, and that KPMG in turn did so under pressure from the government. *United States v. Stein*, 440 FSupp2d 315, at 324–25 (D.N.Y. 2006).

8 *United States v. Stein*, S1 05 Crim. 0888 (S.D.N.Y.) (LAK), at 38.

9 The McNulty Memorandum can be found at *www.usdoj.gov/dag/speech/2006/mcnulty_umemo.pdf.*

10 McNulty Memorandum at VII.2. While prosecutors are told that they are limited as to when they may ask for the waiver, the McNulty Memorandum still concludes that once the request is authorized, "[p]rosecutors may always favorably consider a corporation's acquiescence to the government's waiver request in determining whether a corporation has cooperated in the government's investigation" and that no authorization is needed for voluntary waivers.

11 McNulty Memorandum at VII.3.

12 The indictment can be found at *www.wsj.com/public/resources/documents/EYIndictment20070530.pdf.*

13 *United States v. Coplan*, 07 Crim. 453 (S.D.N.Y.) (SHS), at ¶7.

14 *Cheek v. United States*, 498 US 192, at 201 (1991).

15 *Id.,* at 202.

16 *United States v. Coplan*, 07 Crim. 453 (S.D.N.Y.) (SHS), at ¶14; *see* ¶¶22, 23.

17 *See, e.g., id.* at ¶¶45, 46, 47(a), (b).

18 *See, e.g., id.* at ¶29(c).

19 *See, e.g., id.* at ¶¶14, 46(a), 49.

20 *See, e.g., id.* at ¶¶76(u), (v), (w).

21 *See, e.g., id.* at ¶¶76(y), (ii).

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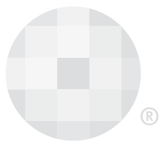

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