

New York Law Journal

SECURITIES LITIGATION & REGULATION

Monday, December 18, 2006

ALM

The Rise of Deferred Prosecution Agreements

While such pacts can keep a company alive, they come at a cost.

BY SCOTT A. RESNIK
AND KEIR N. DOUGALL

FOR A PUBLIC COMPANY in the crosshairs of a federal criminal probe into securities law violations, the stakes cannot get much higher. Mere indictment—which can trigger onerous reporting requirements, civil lawsuits, loss of government contracts and drastic business losses—can be a virtual corporate death sentence. Yet a scorched earth defense can sometimes be an unduly risky course where actual wrongdoing has taken place.

A corporation's criminal liability is a near strict liability proposition when officers or employees have violated the law. In such a predicament, where the government cannot be persuaded to limit its case to the employee wrongdoers, counsel's pursuit of a deferred prosecution agreement (DPA) or non-prosecution agreement (NPA) with the Department of Justice (DOJ) may be the last best hope for a company hoping to stave off the consequences of an imminent criminal charge.

What Are They?

A DPA or NPA is an agreement entered into between the government and a target corporation whereby the government agrees to either dismiss a filed criminal charge (in the case of a DPA) or refrain from filing any charges (in the case of an NPA), in exchange for the target corporation agreeing to reform its conduct, pay restitution to its victims and submit to government oversight over a set period of time.

Notably, these agreements require corporations to admit the unlawful conduct and toll statutes of limitation, so in the case of a breach by the corporation, the prosecutor is virtually guaranteed to obtain a conviction.

Scott A. Resnik and Keir N. Dougall are both former federal prosecutors and partners in the white collar criminal practice at Katten Muchin Rosenman in New York.

As recently as 2003, such agreements were rarely pursued by the DOJ. However, as the government has come to recognize the need to temper its zeal to combat white-collar crime with a concern to safeguard against the often sizeable collateral consequences of a corporate conviction on innocent employees, shareholders and the market, the DPA and NPA have become recently popular.

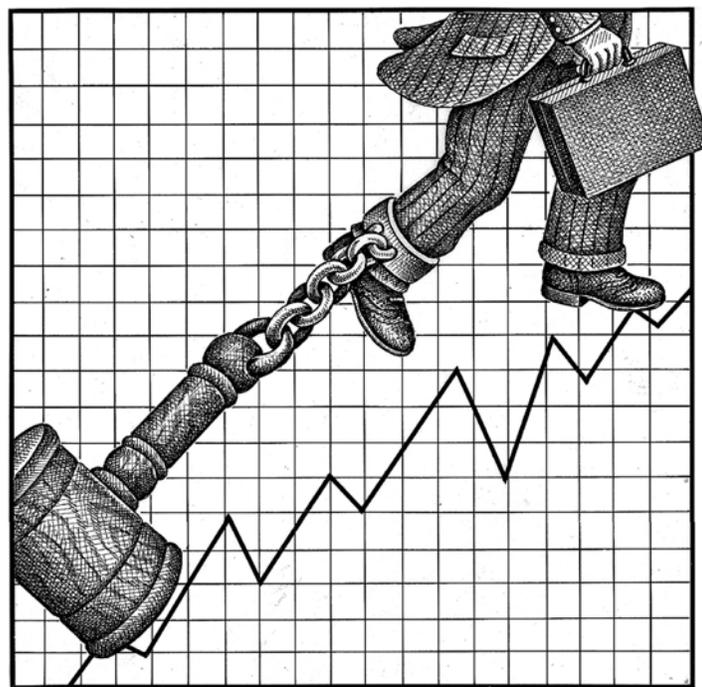
While not yet the norm in corporate investigations, the trend has been for federal prosecutors to consider DPAs and NPAs in circumstances where defense counsel can convincingly demonstrate a company's earnest desire to remedy past misconduct and reaffirm its commitment to good corporate citizenship. However, while DPAs and NPAs can enable a corporation to survive and even continue to prosper in the wake of a criminal investigation, they come at a cost.

Understanding the promise and pitfalls of DPAs and NPAs, therefore, is essential for counsel helping corporate clients to navigate through the rocks and shoals of criminal investigations.

Corporate Criminal Liability

The theory of respondeat superior, whereby corporations have civil liability for wrongdoing committed by employees acting within the scope of their employment, is a concept nearly as old as the corporation itself.

American law, however, was less eager to accept the concept of corporate criminal liability. Traditional resistance focused on the jurisprudential requirement that criminal violations be comprised not only of an actus reus (guilty act), but also a mens rea (guilty mind, e.g., criminal intent). Entities created by law, such as corporations, it was generally believed, were not capable of forming such criminal intent.



ART BY NEWSCOM

However, by the first decade of the 20th century the U.S. Supreme Court cleared this conceptual hurdle and held that a corporation could be held criminally liable for the acts or omissions of an employee acting within the scope of his employment.¹ Ever since, courts have had no difficulty in imputing an employee's wrongful intent, or mens rea, to his or her corporation.

The corporation, therefore, can be criminally liable for the intentional malfeasance of an employee committed during the course of the employee's employment and in furtherance of the corporation's business.² Further, under federal common law such vicarious corporate criminal liability can attach regardless of the employee's position within the corporation.³

With near automatic criminal liability attaching to the corporation for employee malfeasance, corporations face "virtually strict corporate liability for the criminal conduct of employees."⁴ Accordingly, once the prosecutor puts together a case against the employee wrongdoer, the case against the corporation is likewise complete. Whether to charge the

corporation is therefore reduced largely to a question of prosecutorial discretion.⁵

Prosecution and Consequences

Prosecutors are most inclined to seek corporate charges when they believe wrongful conduct permeates the corporation's culture, where the wrongful actors cannot be classified as rogue employees, but rather reflect the entity's corrupted business values.

Through the criminal prosecution of a corporation—as opposed to just the accused employees—a prosecutor may seek to deter similar behavior throughout an entire industry. As one Justice Department official has commented: “Prosecuting the corporation criminally... gives an opportunity to send a very powerful message of deterrence... that can resound throughout an industry and cause other participants in the industry to change their behavior, and can even have effects across the entire economy.”⁶

While corporate prosecutions can further legitimate law enforcement goals, they also come with significant collateral consequences.

Typically, the larger the corporate target, the greater the collateral consequences on innocent corporate stakeholders. The reality is that few public or regulated companies can withstand the uncertainties and consequences that flow from an unresolved federal criminal indictment, much less conviction.

The stigma of indictment alone is likely to cause the flight of clients, precipitous loss of business, plummeting stock prices, and onerous reporting obligations. Many entities would not survive as viable concerns long enough to defend themselves at trial.

Accordingly, the pressure on corporate counsel to avoid indictment is dramatic. Likewise, the prosecutor should hesitate to “pull the trigger” where to do so would cause unjustifiable harm to shareholders, employees and markets.

The indictment and subsequent collapse of accounting giant Arthur Andersen in March 2002 brought home to prosecutors and defense counsel alike both the vulnerability of large corporations to federal criminal charges and the large-scale collateral consequences that can flow from such charging decisions.

The U.S. Supreme Court's reversal of Arthur Andersen's conviction was undoubtedly cold comfort to the tens of thousands of employees who lost their jobs after the government's indictment and conviction of the company.

Enter Deferred Prosecutions

To better guide prosecutorial decision making in this high-profile, high-stakes arena, in January 2003, the Department of Justice updated its guidance on corporate prosecutions. The memorandum, popularly known as the “Thompson Memo,” after Deputy Attorney General Larry Thompson who oversaw its creation, instructed federal prosecutors to explicitly consider “granting a corporation immunity or amnesty or pretrial diversion... in exchange for cooperation when a corporation's timely cooperation appears to be necessary to the public interest and other means of obtaining the desired cooperation are unavailable or would not be effective.”⁷

While much of the Thompson Memo had its antecedents in the Department's prior guidance on corporate prosecutions—the 1999 “Holder Memo”—its significance lay in its highlighting of alternatives to corporate indictment; its emphasis on the authenticity

of the corporation's cooperation; and its continued focus on the collateral consequences of criminal charges. In so doing, the Thompson Memo effectively opened the door to the use of DPAs and NPAs.⁸

The DOJ's most recent guidance on corporate prosecutions, issued on Dec. 12, 2006, by Deputy Attorney General Paul J. McNulty (“McNulty Memo”) reinforced this trend.⁹ Although the McNulty Memo imposed new restrictions on prosecutors seeking waiver of corporate privileges and to deter corporate payment of employee legal fees, it reaffirmed the Department's focus on DPAs and NPAs by instructing prosecutors to consider factors similar to those outlined in the Thompson Memo when making corporate charging decisions.

*Because both DPAs and NPAs
come with substantial costs,
they should only be considered
where the corporation
determines that actual
wrongdoing has occurred and
the likelihood
of indictment is high.*

Specifically, the McNulty Memo directs prosecutors to weigh the following factors when evaluating whether a corporation should be charged or considered for a DPA:

- (1) the nature and seriousness of the offense;
- (2) the pervasiveness of wrongdoing within the corporation;
- (3) the corporation's history of similar conduct;
- (4) the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents;
- (5) the existence and adequacy of the corporation's pre-existing compliance program;
- (6) the corporation's remedial actions;
- (7) the collateral consequences on shareholders, employees, pension holders and the public impact of a prosecution;
- (8) the adequacy of the prosecution of the individuals responsible for the corporation's malfeasance; and
- (9) the adequacy of remedies such as civil or regulatory enforcement actions.¹⁰

Prior to the McNulty, Thompson and Holder Memos, federal prosecutors trying to evaluate the appropriateness of deferred prosecutions were largely “left to their own discretion, with few if any applicable standards upon which to rely.”¹¹ The U.S. Attorney's Manual's guidance on deferred prosecutions was limited to prosecutions of individuals and the enumerated considerations were thus “nonsensical in the corporate context.”¹²

As a result, deferred prosecutions in the 1990s were a relative rarity.¹³ However, the 2003 Thompson Memo gave federal prosecutors a framework within which to evaluate corporate conduct and instructed them to consider DPAs and NPAs in appropriate circumstances. DPAs and NPAs, as a result, have grown more prevalent in the last three years.

How to convince a prosecutor unwilling to decline a corporate prosecution that a DPA or NPA is the next most appropriate course can still be a daunting

challenge. With limited bargaining leverage, counsel must convince the prosecutor that the corporation is prepared to cooperate, reform and remedy past misconduct, while avoiding overly burdensome conditions as the price of the agreement.

For defense counsel navigating these only partially charted waters, recent DPAs and NPAs between the DOJ and corporations suggest that counsel should make every effort to demonstrate that an outcome short of a corporate conviction will, in the end, serve the interests of justice. The lessons learned and costs paid by parties that have made such a showing and convinced prosecutors to enter these agreements offer guidance, and warnings.

Computer Associates

In September 2004, the Department of Justice agreed to resolve securities fraud and obstruction allegations against Computer Associates (CA) with a DPA.

The government's investigation had revealed that during each quarter of its 2000 fiscal year, CA had fraudulently booked revenue in connection with software licenses in order to meet or exceed Wall Street consensus earnings estimates. Further, the government's investigation uncovered evidence that CA and certain executives had engaged in a systematic effort to obstruct the investigation by falsely denying that revenue had been booked improperly.¹⁴

However, while the DOJ took a grave view of CA's conduct—accusing it of having perpetrated “a massive accounting fraud that cost public investors hundreds of millions of dollars”—and threatened that “such conduct will not be tolerated [and] will be met with severe penalties,” the government was nonetheless persuaded to resolved pending federal charges with a DPA.¹⁵

The government's decision reflected the collateral consequences of an indictment on innocent employees and stakeholders and CA's commitment to reform.

The DPA imposed severe conditions on CA, requiring the company to acknowledge and accept responsibility for its wrongdoing; agree to continue to cooperate; agree to continue to take numerous remedial steps to ensure that fraud did not recur; and agree to pay \$225 million in restitution in addition to approximately \$163 million CA had already agreed to pay to victimized shareholders.

The DPA also required CA to adopt wide-ranging internal reforms including the termination of responsible and uncooperative managers; ensuring that no less than two-thirds of CA's board would consist of independent directors; establishing enhanced governance procedures and an ethics program; and reorganizing the company's finance and internal audit functions. CA also agreed to the appointment of an independent examiner with the power to review its compliance with the agreement.¹⁶

In return for these commitments from CA, the government agreed to recommend that prosecution of CA be deferred “for a period of 18 months from the date of the Court's order appointing the Independent Examiner or until such time as the Independent Examiner's term of engagement is completed, whichever is later” and that if CA complied with the agreement, it would dismiss the charges at the end of the period.¹⁷ The resolution of the CA matter demonstrates that the government will consider resolving even grave and obstructive conduct with a DPA where it is convinced that a responsible corporate citizen can emerge from reforms.

Micrus Corporation

In March 2005, the DOJ announced that it had entered into an NPA to resolve an investigation into violations of the Foreign Corrupt Practices Act (FCPA) by Micrus Corporation, a privately held medical device distributor.

The government determined that, among other things, Micrus had made disguised payments totaling over \$100,000 to doctors employed at public hospitals in Europe in return for the hospitals' purchase of medical devices from Micrus. Significantly, however, Micrus itself greatly assisted the government in its investigation by voluntarily disclosing the results of its own internal investigation into related allegations.¹⁸

Largely influenced by Micrus' cooperation, the government agreed not to file FCPA charges against the company and resolved the matter with an NPA. However, Micrus still had to agree to significant penalties and reforms.

Specifically, Micrus had to accept responsibility for its conduct, pay \$450,000 in penalties, and continue to cooperate. Micrus was also bound to implement an FCPA compliance program and institute internal controls to prevent future violations. The NPA also required Micrus to retain an independent compliance expert for three years.

In entering the NPA, the government credited Micrus' voluntary disclosure of wrongdoing; its "prompt disciplinary action respecting the officers and employees primarily responsible for the conduct;" its on-going cooperation; and "the absence of any prior FCPA-related or other criminal history at Micrus."¹⁹ The government's resolution of the Micrus matter demonstrates that prosecutors will rethink bringing criminal charges when a company is prepared to make voluntary disclosure of wrongdoing, particularly when the disclosing company does not have a history of similar violations.

Bristol-Myers Squibb

In June 2005, Bristol-Myers Squibb Company (BMS) and the DOJ entered into a DPA to resolve allegations of securities fraud.

During 2000 and 2001, BMS concealed its use of financial incentives to induce wholesalers to purchase more of its products than product demand warranted so that BMS could report artificially higher sales and earnings in a practice known as "channel stuffing."

Federal investigators were especially concerned because BMS "had gone through a channel-stuffing problem in the early 1990s" which although smaller in scope, indicated "a corporate attitude that placed earnings ahead of honesty."²⁰ Nevertheless, the government was still willing to resolve its investigation of BMS with a DPA. The costs to BMS in terms of internal reforms and monetary payments, however, were high.

The terms of the DPA required BMS to, among other things, take extensive remedial action; acknowledge responsibility for its conduct; continue to cooperate with the government; accept an independent monitor to report on BMS's future compliance with the agreement and applicable securities laws; and make a \$300 million restitution payment in addition to approximately \$539 million BMS had already agreed to pay to victimized shareholders.

In return, the government agreed to defer BMS's prosecution and dismiss the filed securities fraud charges after 24 months if BMS complied with the agreement.²¹ The government's resolution of the BMS

case indicates that prosecutors confronting even serious and potentially repetitive conduct will resolve a matter short of a corporate conviction if they are convinced that robust safeguards and remediation efforts are in place.

In the government's press release concerning BMS, one can find many of the threads that should be woven together when negotiating a resolution of potential corporate criminal liability:

We balanced the need for punishment with an acknowledgement that this company provides great value and its work should continue.[.] At the same time, we have compensated the victimized shareholders and are prosecuting individuals responsible for the fraud at BMS. This approach meets the needs of justice, sends a deterrent message to others and does not cause undue harm to an otherwise outstanding company, its shareholders and employees.²²

Conclusion

The result in BMS and similar cases suggest that where a prosecutor is unwilling to decline a prosecution, a corporation with potential exposure to criminal liability for securities law violations should develop and advance factors that will address the traditional concerns of a prosecutor.

Corporate prosecutions generally seek to achieve the goals of any prosecution: education and deterrence in the regulated community, sequestration and rehabilitation of offenders, compensation of victims and vindication of law.

Where these interests can be addressed with prosecutions of responsible individuals, by voluntary remedial action, and perhaps even by civil remedies, the prosecutor should be asked to consider an outright declination. If this fails, however, corporate counsel should engage the prosecutor in a dialogue about how to address these concerns without a corporate conviction.

The cases examined above demonstrate that prosecutors will agree to enter into DPAs and NPAs where it is possible to address these interests, even in the wake of serious misconduct. Prosecutors have been favorably influenced by the willingness of corporations to institute fundamental reforms like those undertaken by CA, Micrus and BMS where they believe that a good corporate citizen can emerge from reform.

However, because both DPAs and NPAs come with substantial costs, they should only be considered where the corporation determines that actual wrongdoing has occurred and the likelihood of indictment is high.

The government will require the corporation to pay for any independent examiner. Implementing changes to board structures and new corporate compliance, oversight, reporting and disclosure mechanisms will be burdensome. Further, in addition to restitution payments, there are substantial indirect costs associated with allocating employee time and effort to comply with these agreements.

Also, during the term of the agreement, the government and any independent examiner will wield significant power over the corporation and subject it to in-depth scrutiny. For instance, BMS's board recently removed the company's CEO and general counsel on the recommendation of its independent examiner. According to press reports, the examiner's recommendation came after the discovery of potential anti-trust violations entirely unrelated to the securities fraud allegations underlying BMS's deferred prosecution.²³

Finally, DPAs and NPAs are designed to lead to a virtually automatic conviction of the corporation that has breached one of these agreements.

In practice, a corporation may have few options but to accept these costs where there is potential criminal liability. Nonetheless, in all cases, the focus should be on resolving potential criminal liability without unwarranted corporate disruption.²⁴

Where a declination is unavailable, however, resolving potential corporate criminal liability through an NPA or DPA can avoid the likely draconian consequences of a criminal conviction.



1. *New York Cent. & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 491-92 (1909).

2. See, e.g., *United States v. Cincotta*, 689 F.2d 238, 241-42 (1st Cir. 1982).

3. See, e.g., *United States v. Koppers Co.*, 652 F.2d 290, 298 (2d Cir. 1981) (rejecting arguments that corporation can only be accountable for acts of high managerial agents).

4. Howard W. Goldstein, "Corporate Crime: Corporate Liability Revisited," *New York Law Journal*, May 2, 2002, p. 5.

5. See *id.*

6. Panel discussion, "Bigger Carrots and Bigger Sticks: Issues and Developments in Corporate Sentencing," 11 *Fordham J. Corp. & Fin. L.* 161, 167 (2006) (comments of Timothy Coleman, Senior Counsel to Deputy Attorney General James Comey).

7. Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003) at Part VI.B., available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm [hereinafter "Thompson Memo"].

8. See Benjamin M. Greenblum, "Note: What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements," 105 *Colum. L. Rev.* 1863, 1875 (2005).

9. Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006), available at http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf [hereinafter "McNulty Memo"].

10. *Id.* at Section III A.

11. F. Joseph Warin & Jason C. Schwartz, "Deferred Prosecutions: The Need for Specialized Guidelines for Corporate Defendants," 23 *J. Corp. L.* 121, 127 (1997).

12. *Id.*

13. See Greenblum, 105 *Colum. L. Rev.* at 1872-73 (discussing DPAs in the cases of Salomon Brothers (1992), Prudential Securities (1994) and Coopers & Lybrand (1996)).

14. Justice Department Press Release, Former Computer Associates Executives Indicted on Securities Fraud, Obstruction Charges, Sept. 22, 2004 (available at http://www.usdoj.gov/opa/pr/2004/September/04_crm_642.htm).

15. *Id.*

16. *Id.*

17. Computer Associates Deferred Prosecution Agreement ¶¶23-24 (available at <http://www.usdoj.gov/dag/cftf/chargingdocs/compassocagreement.pdf>).

18. Justice Department Press Release, Micrus Corporation Enters Into Agreement to Resolve Potential Foreign Corrupt Practices Act Liability, March 2, 2005 (available at http://www.usdoj.gov/opa/pr/2005/March/05_crm_090.htm).

19. Micrus Corporation Non-Prosecution Agreement ¶¶3, 5, 20 (available at <http://www.usdoj.gov/dag/cftf/chargingdocs/micrusagreement.pdf>).

20. C. Christie & R. Hanna, "A Push Down the Road of Good Corporate Citizenship: The Deferred Prosecution Agreement Between the U.S. Attorney for the District of New Jersey and Bristol-Myers Squibb Co.," 43 *Am. Crim. L. Rev.* 1043, 1048, 1056-57 (2006).

21. Bristol-Myers Squibb Deferred Prosecution Agreement ¶4 (available at <http://www.usdoj.gov/usao/nj/press/files/pdf/files/deferredpros.pdf>).

22. Justice Department Press Release, Bristol-Myers Squibb Charged With Conspiring to Commit Securities Fraud; Prosecution Deferred for Two Years, June 15, 2005 (available at http://www.usdoj.gov/usao/nj/press/files/bms0615_r.htm).

23. "Board Members at Bristol-Myers Told to Fire CEO," *Wall Street Journal*, Page A1, Sept. 12, 2006.

24. See D. Alonso, "Use Caution in Negotiating Deferred Prosecution Agreements," *N.Y.L.J.*, March 1, 2006.