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DEFERRED PROSECUTION AGREEMENTS: WHAT IS THE COST OF STAYING IN BUSINESS?

by

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In the January 2003 Department of Justice memorandum relating to the prosecution of business organizations, Deputy Attorney General Larry Thompson expanded prior guidance on prosecuting corporate fraud by focusing on cooperation. He instructed federal prosecutors to consider amnesty or pre-trial diversion for corporations that completely cooperate with investigators in a timely fashion. In light of these marching orders, federal prosecutors have increasingly relied upon “deferred prosecution agreements” as a form of pre-trial diversion to exact corporate reforms, large-dollar restitution, and cooperation from companies under investigation. Deferred prosecution agreements give corporations a period of probation, during which time charges are held in abeyance, so that they can clean house and cooperate. While these agreements provide corporations the ability to swiftly resolve investigations and reassure shareholders and employees of the company’s continued viability, the agreements also create risks through increased exposure to civil liability and financial penalties and heightened tensions between the company and its employees resulting from the waiver of attorney-client and work-product privileges.

Under a deferred prosecution agreement, a corporation is given a period of time, usually 18 months to several years, during which the Justice Department will hold off on filing an indictment. In exchange, the corporation will acknowledge that the Government can prove its case, will fully cooperate with the investigation of its culpable employees, and will enact Sarbanes-Oxley-style reforms relating to management, reporting requirements, and audit procedures. If the company can demonstrate reform, at the end of the probationary period the Justice Department will dismiss all charges.

In the post-Andersen era, the advantages of deferred prosecution to a corporation that wishes to stay in business are obvious. Many companies will enter into what may seem an onerous deal in order to avoid the stigma of a highly publicized indictment and the penalties that may follow a felony conviction, and to use the agreement as a mechanism to sell reforms to the board of directors. For example, in November 2004, Computer Associates elected to enter into a deferred prosecution agreement with the United States Attorney’s Office for the Eastern District of New York, after an extensive investigation had revealed accounting fraud and obstruction of justice by numerous officers and executives. In exchange for admissions of wrongdoing, significant reforms that included new management, auditors, governance procedures, a \$225 million restitution fund to settle shareholder suits, and an eighteen-month period of supervision by the Government, the company was allowed to remain in business, workers kept their jobs, and the stock price increased.

Similarly, late last year, American International Group (AIG) and several subsidiaries entered into a deferred prosecution agreement, resulting in \$80 million in fines, \$46 million in disgorgement, and compliance reforms. Of great significance for AIG, this agreement also allowed for the ultimate dismissal of all charges with prejudice, provided that AIG cooperated with investigators in ongoing investigations.

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The cooperation requirement of such agreements, however, can raise interesting problems for corporations, most notably with respect to the waiver of the attorney-client and work-product privileges. For example, in the Computer Associates case, an additional term of the agreement essentially made Computer Associates an investigative partner of the FBI and SEC in their investigation of former CEO Sanjay Kumar and others. Under the agreement, Computer Associates had to waive the attorney-client and work-product privileges relating to its internal investigation and cooperate with the Government's investigation of the former executives. The Government was able to use the evidence obtained during the internal investigation, including all reports and relevant documents.

The Computer Associates agreement highlighted two difficult questions that must be addressed before entering into such agreements. First, at what point do the Government's demands outweigh the benefits of continued vitality? Second, what kind of corporate environment is created when employees know that an employee will be served up to the Government for the company's greater good?

To answer these questions, corporate counsel generally should consider several factors before entering into a deferred prosecution agreement. First, a deferred prosecution agreement may have adverse consequences upon subsequent or pending civil litigation. To the extent outstanding shareholder suits are not resolved in the agreement, public disclosure of wrongdoing will affect the civil litigation as admissions and disclosures are likely discoverable. While a company is not required to admit guilt as part of the agreement, the company very often will be required to stipulate to the Government's presentation of facts — a stipulation that a plaintiff will seek to use against the corporation in later civil proceedings. Indeed, with the almost inevitable consequence of class action lawsuits, the stakes can be enormous.

Second, the waiving of attorney-client privilege, as well as any joint defense privilege, in the context of a criminal investigation may not be limited and may cause a waiver of such privilege in the civil context. Many federal appellate courts do not recognize a selective waiver of privilege. In those circuits, what was disclosed to the investigators can and most likely will be disclosed to plaintiffs' counsel. In some courts, most notably the Southern District of New York, the use of a confidentiality agreement has provided some limited protection to the disclosure of SEC or internal investigations, but such protection will be reviewed on a case-by-case basis.

Moreover, the deferred prosecution agreement will likely contain restrictions that may affect the ability to conduct business. For example, for companies accused of procurement fraud, the Federal Acquisition Regulations provide that "adequate" evidence reflecting fraud may result in a suspension of Government contracts. 47 C.F.R. § 9.407-2. In some cases, the effect of accepting the Government's facts may be the same as if an indictment were handed up.

Finally, the agreement may affect company morale and the relationships among key corporate executives. Arguably the most important benefit to the Government from a deferred prosecution agreement is to obtain cooperation and accordingly sufficient evidence to prosecute culpable individuals. Counsel and senior management should be aware that in many instances, cooperation causes mistrust and self-dealing among senior employees, as everyone is viewed as looking out for their own best interests, as opposed to the best interests of the company. Corporate counsel must weigh the effect upon the corporate environment from knowing that the Government and the corporation will be working together.

There is no question that entering into a deferred prosecution agreement can be of enormous value to a corporation under investigation. One need look no further than the MCI deferred prosecution agreement. Once the subject of scorn for its corporate practices, MCI is now the target of a giant bidding war between phone rivals. However, when deferred prosecution appears to be a logical resolution, counsel should minimize the collateral effects of the agreement by negotiating an outcome that: (1) attempts to simultaneously resolve civil liability with the SEC or private litigants; (2) limits the admissions and the disclosure of attorney-client materials in time and scope to only those necessary to effectuate the agreement; (3) incorporates a confidentiality agreement with the Government in the hope that such agreement can offer some level of protection against later civil litigation; and (4) works to reassure employees that cooperation with the Government is as limited as necessary to keep the company in business.