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THE CURRENT ENFORCEMENT ENVIRONMENT AND THE CORPORATE RESPONSE

SEC and Justice Department Policies Require Self-Reporting, Extensive Cooperation, and Remediation by Corporations for Favorable Settlements of Enforcement Actions, Most Notably the Waiver of Privilege Protections. Despite Widespread Protests that the Government Has Gone too Far, Recent Deferred Prosecution Agreements and SEC Settlements Suggest that Full Compliance Remains the Key to Avoiding Outsized Monetary Penalties. The First of a Two-Part Article.

By Hector Gonzalez and Claudius O. Sokenu *

Until a few years ago, federal enforcement agencies and regulators had been content to react to white collar crime and regulatory violations, meting out sanctions after discovering wrongdoing.¹ Now, in the wake of numerous high-profile criminal prosecutions and civil enforcement actions, federal regulators and enforcement agencies have become more proactive, demanding that corporations identify and report their own violations.

We first describe today's enforcement environment, which places a significant premium on self-reporting and cooperation, and then turn to how corporations have responded to this new environment.

THE SEC'S DEMANDS

The Seaboard Report

On October 23, 2001, the Securities and Exchange Commission, pursuant to Section 21(a) of the Securities Exchange Act, issued a report of investigation known as

¹ See, e.g., Stephen M. Cutler, Remarks before the District of Columbia Bar Association (Feb. 11, 2004), available at <http://www.sec.gov/news/speech/spch021104smc.htm>.

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the Seaboard Report. The Seaboard Report outlines some of the criteria that the SEC will use to assess the extent to which a company's self-policing and cooperation efforts will influence the SEC's decision to bring an enforcement action against that company when it believes that company may have violated the federal securities laws.²

In its press release announcing the Seaboard Report, the Commission identified four factors that may influence its evaluation of a company's cooperation: (i) self-policing before the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top; (ii) self-reporting misconduct, including conducting a thorough review of its nature, extent, origins and consequences, and promptly, completely, and effectively disclosing it to the public, regulators, and self-regulators; (iii) remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and (iv) cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts.³

While making clear that it was not adopting a rule or limiting its enforcement discretion, the Commission indicated that, when a company takes the steps outlined in the Seaboard Report, the SEC may exercise its discretion and "credit" the company for its remedial efforts. Such "credit for cooperative behavior," the Commission says, "may range from the extraordinary step of taking no enforcement action at all to bringing

reduced charges, seeking lighter sanctions, or including mitigating language in documents the Commission uses to announce and resolve enforcement actions."⁴

The Seaboard Report outlined the steps taken by Seaboard Corporation after it discovered that it may have violated the federal securities laws. Within a week of learning about the misconduct, Seaboard conducted a preliminary investigation and advised company management who, in turn, advised the board of directors' audit committee. Subsequently, Seaboard's board authorized the company to engage independent outside counsel to conduct a detailed investigation. Four days later, Seaboard dismissed the controller who caused the inaccuracies in its books and records along with two others who had inadequately supervised the controller. A day later, Seaboard publicly disclosed that it would restate its financial statements.⁵ The price of Seaboard's shares did not drop after the announcement or after the restatement was published. Furthermore, Seaboard provided the SEC with all relevant information concerning the alleged violations. Seaboard produced details of its internal investigation (including notes and transcripts of interviews) and declined to invoke its attorney-client privilege, work product protection or other privileges or protections with respect to the investigation. In addition, Seaboard strengthened its financial reporting processes to address the controller's conduct.

Based on Seaboard's conduct, the Commission did not bring enforcement action against the Company. However, in announcing its settlement with the controller, the Commission stated that Seaboard had violated Sections 13(a) and 13(b)(2) of the Exchange Act.

After outlining the company's cooperative efforts, the Seaboard Report listed thirteen criteria that the staff will

² *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Rel. No. 34-44969 (October 23, 2001), available at <http://www.sec.gov/litigation/investreport/34-44969.htm>.

³ Press Release, SEC Issues Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion (Oct. 23, 2001), available at <http://www.sec.gov/news/headlines/prosdiscretion.htm>.

⁴ See *In the Matter of Baker Hughes Inc.*, Rel. No. 34-44784 (Sept. 12, 2001), for an example of an enforcement action in which the Commission included mitigating language in the document used to announce and resolve an enforcement action.

⁵ *In the Matter of Gisela de Leon-Meredith*, Rel. No. 34-44970 (Oct. 23, 2001), available at 2001 WL 1268303.

use to determine whether to recommend enforcement action. These were: (i) nature of the misconduct involved; (ii) how did the misconduct arise; (iii) where in the organization did the misconduct occur; (iv) duration of the misconduct; (v) how much harm has the misconduct inflicted upon investors and other corporate constituencies, and did the share price of the company's stock drop significantly upon its discovery and disclosure; (vi) how was the misconduct detected and who uncovered it; (vii) how long after discovery of the misconduct did it take to implement an effective response; (viii) what steps did the company take upon learning of the misconduct; (ix) what processes did the company follow to resolve many of these issues and ferret out necessary information; (x) did the company commit to learn the truth, fully and expeditiously; (xi) did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation; (xii) what assurances are there that the conduct is unlikely to recur; and (xiii) is the company the same company in which the misconduct occurred, or has it changed through a merger or bankruptcy reorganization. The most noteworthy aspect of this list is the Commission's willingness to disclose how it plans to make enforcement decisions where companies self-police and cooperate with its investigations.

The Penalties Statement

In the aftermath of vociferous complaints by two Republican commissioners, the business community and the defense bar about the multi-million dollar penalties that the Commission was extracting from issuers settling securities fraud charges, on January 4, 2006, the Commission took the unusual step of issuing a press release announcing the principles that it (and presumably its staff) will consider when determining whether and to what extent monetary penalties should be imposed on issuers in settled enforcement actions (the "Penalties Statement").⁶

The Commission published its Penalties Statement against the backdrop of two settled enforcement actions involving allegations of financial fraud. In the first action, McAfee Inc., a Santa Clara, California-based manufacturer and supplier of computer security and antivirus tools, agreed to pay \$50 million to settle allegations that, from 1998 through 2000, it inflated its

cumulative net revenue by \$622 million.⁷ In the second action, Applix Inc., a Westborough, Massachusetts-based company that develops, sells and supports business performance management software, engaged in a fraudulent scheme to improperly recognize \$898,000 and \$341,000 in revenues on two separate transactions that allowed Applix to meet its revenue projections for fiscal year 2001 and understate its net loss by over 30 percent for the second quarter of 2002.⁸ Notwithstanding this conduct, the Commission accepted an offer of settlement that did not include the imposition of a monetary penalty on Applix.

In his speech announcing the McAfee and Applix settlements and the corporate penalties principles, Chairman Cox, perhaps concerned that the issue of imposing multi-million dollar penalties against issuers had divided the Commission under his predecessor, emphasized that the Commission "unanimously" agreed on the principles outlined in the statement.⁹

After tracing the history of the Commission's authority to seek monetary penalties against issuers back to 1990 when Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act and the more recent fair funds provisions under Section 308 of the Sarbanes-Oxley Act of 2002, the Commission's Penalties Statement outlined two principal factors and seven others that it will consider when deciding whether to impose monetary penalties on an issuer.

The first principal factor is whether "a corporation has received a direct and material benefit from the offense, for example, through reduced expenses or increased revenue," or if the issuer was in any other way "unjustly enriched." At one end of the monetary penalty continuum, issuers whose shareholders have "received an improper benefit as a result of the violation" offer the strongest case for the imposition of a monetary penalty. At the other end, issuers whose shareholders are the "principal victims of the securities law violation," offer the weakest case for the imposition of a penalty.

⁶ Press Release, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), available at <http://www.sec.gov/news/press/2006-4.htm>.

⁷ *SEC v. McAfee, Inc.*, Lit. Rel. No. 19520 (Jan. 4, 2006).

⁸ *In the Matter of Applix, Inc.*, Rel. No. 34-53049 (Jan. 4, 2006).

⁹ See SEC Chairman Christopher Cox, Statement of Chairman Cox Concerning Objective Standards for Corporate Penalties, available at <http://www.sec.gov/news/speech/spch010406cc.htm> (Jan. 4, 2006).

To illustrate this point, Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, juxtaposed the allegations in the McAfee and Applix cases, and reasoned that, in McAfee, the imposition of a \$50 million penalty was justified because, among other things, McAfee (and presumably those investors who were fortunate enough to sell McAfee's stock at the height of the alleged violations) benefited from its fraudulent conduct through the acquisitions made with its inflated stock.¹⁰ Conversely, in Applix, the company's shareholders did not similarly benefit from the allegedly violative conduct and the Commission did not find any evidence of other direct benefits to Applix.

The second principal factor is the "degree to which the penalty will recompense or further harm the injured shareholders."¹¹ According to the Commission, although the "imposition of a penalty on the corporation itself carries with it the risk that shareholders who are innocent of the violation will nonetheless bear the burden of the penalty," in certain cases, a monetary penalty may be appropriate because the penalty may be "used as a source of funds to recompense the injury suffered by victims of the securities law violations." Again, using the McAfee and Applix settlements to illustrate the Commission's thinking, Linda Chatman Thomsen stated that the imposition of a monetary penalty in McAfee was appropriate because "today, McAfee is financially strong and the [\$50 million] penalty it has agreed to pay is unlikely to cause McAfee shareholders undue hardship."¹² On the other hand, the Commission reasoned that it would not have been appropriate to impose a monetary penalty on Applix since it is a "relatively small company and a large penalty could have a disproportionate effect on [Applix's] financial situation with hardship flowing to its shareholders."

Additionally, the Commission's decision to impose a monetary penalty on an issuer will be influenced by the "presence of an opportunity to use the penalty as a meaningful source of compensation to injured shareholders . . ." However, the "likelihood a corporate penalty will unfairly injure investors, the corporation, or third parties weighs against its use as a sanction."¹³ In

other words, "[b]ecause the protection of innocent investors is a principal objective of the securities laws," the Commission will not seek to impose a monetary penalty on an issuer where such a penalty is likely to disproportionately harm innocent investors. By way of illustration, in McAfee, the Commission accepted McAfee's offer to pay \$50 million in penalty because the Commission expects that the \$50 million penalty (less administrative fees and expenses) can be effectively distributed to shareholders injured by McAfee's fraud.¹⁴ In Applix, however, a monetary penalty was not sought because "it would be difficult to impose a penalty that would be large enough to make distribution to victims practical without causing undue harm to the company and its current shareholders."

Leaning heavily on the statutory authority to seek monetary penalties (and the accompanying legislative history), the Commission's Penalties Statement outlined seven other factors that will influence its decision to impose monetary penalties in settled enforcement actions.

First, the Commission will be influenced by the need to "deter the particular type of offense" for which the issuer is being charged.¹⁵ Where a penalty will likely serve as a "strong deterrence to others similarly situated," the Commission believes the issuer should pay the monetary penalty. Conversely, where the facts underlying the alleged violation are unique and unlikely to be repeated in other contexts, it is better to impose a monetary penalty on the individual than on the issuer.

Second, the extent of the injury to innocent parties will weigh on the Commission's decision to seek a monetary penalty against an issuer. Here, the "egregiousness of the harm done, the number of investors injured, and the extent of societal harm if the corporation's infliction of such injury on innocent parties goes unpunished, are significant determinants of the propriety of a [monetary] penalty."

Third, where the alleged violations are widespread, the Commission believes it more appropriate to impose a monetary penalty. In McAfee, the Commission alleged that the allegedly violative conduct was pervasive and occurred over a significant period of time.¹⁶

¹⁰ See Linda Chatman Thomsen, Statement Regarding McAfee, Inc. and Applix, Inc. (Jan. 4, 2006), *available at* <http://www.sec.gov/news/speech/spch010406lct.htm>.

¹¹ Penalties Statement, *supra* note 6, at 3.

¹² Statement Regarding McAfee, Inc. and Applix, Inc., *supra* note 10, at 2.

¹³ Penalties Statement, *supra* note 6, at 3.

¹⁴ Statement Regarding McAfee, Inc. and Applix, Inc., *supra* note 10, at 2.

¹⁵ Penalties Statement, *supra* note 6, at 4.

¹⁶ Statement Regarding McAfee, Inc. and Applix, Inc., *supra* note 10, at 2.

Presumably, where the allegedly violative conduct is pervasive and involves management, the Commission is likely to be more inclined to impose a monetary penalty. It remains to be seen whether widespread violative conduct featuring very low level employees will result in the imposition of a monetary penalty. On the other hand, where the allegedly violative conduct is isolated and involves only a few individuals, a monetary penalty would not be appropriate, particularly where the issuer has replaced those individuals responsible for the conduct. For example, in *Applix*, the conduct was limited to a few individuals and only involved two discrete contracts.

Fourth, the Commission will weigh the responsible individuals' intent. The "imposition of a corporate penalty is most appropriate in egregious circumstances, where the culpability and fraudulent intent of the perpetrators are manifest."¹⁷ However, a monetary penalty on the issuer is "less likely to be imposed if the violation is not the result of deliberate, intentionally fraudulent conduct."

Fifth, where the violations are particularly difficult to detect, the Commission believes that a monetary penalty should be imposed. For example, violations of the antibribery provisions of the Foreign Corrupt Practices Act (the "FCPA") are often difficult to detect. Thus, enforcement actions based on the antibribery provisions of the FCPA are more likely to lead to the imposition of monetary penalties.

Sixth, picking up on a theme it first articulated in the Seaboard Report, the Commission stated that it will look to the presence or absence of remedial steps by the issuer in deciding whether to impose a monetary penalty.¹⁸ Here, the Commission stated that its "decisions in particular cases are intended to encourage the management of corporations accused of securities law violations to do everything within their power to take remedial steps, from the first moment that the violation is brought to their attention."¹⁹ Where an issuer promptly takes the remedial steps outlined in the Seaboard Report, the Commission will likely decline to impose a monetary penalty.²⁰ Conversely "failure of

management to take remedial steps is a factor supporting the imposition of a corporate penalty."²¹

Seventh, again drawing on the principles articulated in the Seaboard Report, the Commission believes that when "securities law violations are discovered, it is incumbent upon management to report them to the Commission and to other appropriate law enforcement authorities." When considering whether to impose a monetary penalty, the Commission will consider whether a corporation has reported an offense, or otherwise cooperated with the investigation and remediation of the offense.

Much like the Seaboard Report before it, the Commission's monetary penalty statement sheds light on a confusing process. While by no means novel concepts, the nine factors that will guide the Commission's monetary penalties decisions are likely to better focus settlement discussions between issuers and the Enforcement Division staff.²² For example, an issuer's ability to convince the SEC that the company did not benefit from alleged violations will go a long way toward focusing the Enforcement Division staff on the economic realities of that conduct. Similarly, analyzing investor turnover to demonstrate that current shareholders did not benefit from the alleged violations is also likely to be instructive in settlement discussions. It is perhaps equally helpful to include in these analyses the potential settlement of other related state and federal civil and/or criminal actions and class action lawsuits that typically result from SEC investigations. It remains to be seen how much weight the SEC staff will give to the nine mostly subjective factors enumerated by the Commission in settlement discussions.

The Commission did not, however, address the issue that generated the uproar in the first place: the ever-

footnote continued from previous column...

noted: "Rite-Aid cooperated in the Commission's investigation of this matter, including declining to assert its attorney-client privilege ... and voluntarily providing the Commission staff with full access to an internal investigation conducted by Rite-Aid's counsel," and "the Commission has considered the value of this cooperation in determining the appropriate resolution of this matter").

²¹ Penalties Statement, *supra* note 6, at 4.

²² Stephen M. Cutler, Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), available at <http://www.sec.gov/news/speech/spch042904smc.htm>.

¹⁷ Penalties Statement, *supra* note 6, at 4.

¹⁸ *Id.* See also Seaboard Report, *supra* note 2.

¹⁹ Penalties Statement, *supra* note 6, at 4.

²⁰ See, e.g., *In the Matter of Rite Aid Corp.*, Rel. No. 34-46099 (Jun. 21, 2002) (in *Rite Aid*, a fraud case involving two years of overstated income, and, at the time, the largest restatement of income by a public company, the SEC administrative order

increasing size of the penalties that the Commission was extracting from issuers settling allegations of securities law violations. For example, in July 2003, WorldCom Inc. agreed to pay \$2.25 billion in penalties to settle fraud allegations.²³ In December 2003, Vivendi Universal, S.A. agreed to pay \$50 million in penalties to settle fraud allegations.²⁴ Moreover, between March and December of 2003, four financial services firms agreed to pay a combined total of \$197.5 million in civil penalties, ranging from \$37.5 million to \$65 million, to settle charges relating to the accounting fraud at Enron.²⁵ In the same period, the Commission settled charges relating to the global research analyst conflict-of-interest matters with Citigroup for a staggering \$150 million and \$75 million against Credit Suisse First Boston.²⁶ In the words of then SEC Enforcement Director, Steven Cutler, “penalties this size were once-a-decade occurrences, if that. Now, they are commonplace. Indeed, all but three of the 12 penalties of \$50 million or more obtained in Commission settlements since 1986 were obtained in the last twelve months.”²⁷

The Commission’s statement did not address the size of the penalties that the Commission will seek in future cases. Perhaps the \$50 million penalty that McAfee agreed to pay indicates that change is not afoot. In that case, the Commission will do well to heed Commissioner Atkins’ warning that “if we are not careful ... we might view ourselves as an extension of the plaintiffs’ bar, with similar philosophies and tactics.”²⁸

THE NYSE’S AND NASD’S DEMANDS

Because the SEC regulates both the NYSE and NASD, it is no surprise that both self-regulatory organizations followed in the SEC’s footsteps in their demands for cooperation.

On September 14, 2005, the New York Stock Exchange issued Information Memo 05-65 (the “Cooperation Memorandum”).²⁹ The Cooperation Memorandum makes clear that cooperation with the Exchange is an obligation of member firms. First, it requires that disclosure to the Exchange of reportable matters “must be full, accurate, comprehensible, and timely.” Second, with respect to NYSE investigations or proceedings, members must respond to Exchange requests for written statements, documents, or other information “with responses that are intelligible, accurate, complete and timely, and provid[e] interviews and on-the-record testimony that is forthright and honest.” Third, it states that only a record of “proactive and exceptional” cooperation, such as, *inter alia*, the waiver of attorney-client privilege, can mitigate sanctions.³⁰

Approximately three weeks after issuing the Cooperation Memorandum, the Exchange issued a statement identifying factors that it would consider in determining sanctions.³¹ Like the SEC, the NYSE made abundantly clear that it considers waiver the centerpiece of cooperation, and any corporation facing NYSE investigation must be prepared to waive or risk being punished for not doing so.

²³ *SEC v. WorldCom Inc.*, Lit. Rel. No. 18219 (Jul. 7, 2003) (the WorldCom settlement was to be satisfied, post-bankruptcy, by the company’s payment of \$500 million in cash, and common stock in the reorganized company valued at \$250 million).

²⁴ *SEC v. Vivendi Universal, S.A.*, Lit. Rel. No. 18523 (Dec. 24, 2003).

²⁵ *SEC v. Merrill Lynch & Co., Inc.*, Lit. Rel. No. 18038 (Mar. 17, 2003); *SEC v. J.P. Morgan Chase & Co.*, Lit. Rel. No. 18252 (Jul. 28, 2003); *In the Matter of Citigroup, Inc.*, Rel. No. 34-48230 (Jul. 28, 2003); *SEC v. Canadian Imperial Bank of Commerce*, Lit. Rel. No. 18517 (Dec. 22, 2003).

²⁶ *SEC v. Citigroup Global Mkts. Inc.*, Lit. Rel. No. 18111 (Apr. 28, 2003); *SEC v. Credit Suisse First Boston LLC*, Lit. Rel. No. 18110 (Apr. 28, 2003).

²⁷ Cutler Remarks, *supra* note 1.

²⁸ See Commissioner Paul S. Atkins, Remarks before the Atlanta Chapter of the National Association of Corporate Directors (Feb. 23, 2005), available at <http://www.sec.gov/news/speech/spch022305psa.htm>.

²⁹ See Memorandum from Susan Merrill, Exec. V.P., NYSE’s Div. of Enforcement, to All Members, Member Orgs. and COOs, NYSE Information Memo No. 05-65 (Sept. 14, 2005), available at [http://apps.nyse.com/cmddata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E88525707C004C6DE0/\\$FILE/Microsoft%20Word%20-%20Document%20in%2005-65.pdf](http://apps.nyse.com/cmddata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E88525707C004C6DE0/$FILE/Microsoft%20Word%20-%20Document%20in%2005-65.pdf).

³⁰ With respect to waiver of the attorney-client privilege, the Cooperation Memorandum states that “[t]he essence of cooperation is that facts relevant to an investigation must be made available to Exchange investigators, and as long as those facts are candidly and completely presented, there will be no adverse effect arising from the non-waiver of a privilege.” (footnote omitted).

³¹ See Memorandum from Susan Merrill, NYSE Div. of Enforcement, to All Members, Member Orgs. and COOs, NYSE Information Memo 05-77 (Oct. 7, 2005) [hereinafter Sanctions Memorandum], available at [http://apps.nyse.com/cmddata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E8852570920068314A/\\$FILE/Microsoft%20Word%20-%20Document%20in%2005-77.pdf](http://apps.nyse.com/cmddata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E8852570920068314A/$FILE/Microsoft%20Word%20-%20Document%20in%2005-77.pdf).

Not to be outdone, the National Association of Securities Dealers has also issued a statement emphasizing a respondent's level of cooperation in determining whether, and to what extent, a respondent may be sanctioned.³²

THE JUSTICE DEPARTMENT'S DEMANDS

The Thompson Memorandum

On January 20, 2003, the Department of Justice released a memorandum by then-Deputy Attorney General Larry D. Thompson, entitled "Principles of Federal Prosecution of Business Organizations." The Thompson Memo provided guidance for federal prosecutors deciding whether to prosecute a business.³³ The Thompson Memorandum – in force from January 2003 until superseded on December 12, 2006 – revised the Holder Memorandum.³⁴ The essential purpose underlying the Thompson Memorandum's revisions to the Holder Memorandum was "increased emphasis on and scrutiny of the authenticity of a corporation's cooperation."

Many of the policies in the Thompson Memorandum created a well-documented outcry within the business and legal communities.³⁵ Two criticisms are of particular note. First is the view that the Thompson Memorandum contributed to a coercive "culture of waiver," in which "governmental agencies believe it is

reasonable and appropriate to expect a corporation under investigation to broadly waive [its] attorney client privilege."³⁶ Regardless of whether consideration of a corporation's willingness to waive privilege and withhold payment of employees' attorney fees was explicitly mandatory under the Thompson Memorandum,³⁷ in the view of former United States Attorney General Edwin Meese, the lack of specific and concrete language in the Thompson Memorandum explaining how prosecutors would decide whether to indict, or what weight they would assign to various factors, creates an environment in which corporations effectively must view the factors as mandatory.³⁸

A second criticism of the Thompson Memorandum was that the emphasis on waiver of the attorney-client privilege and work product protections create a counterproductive climate of distrust between corporations and their employees, and undermine companies' compliance programs and procedures. As the ABA noted, "[b]ecause the effectiveness of these internal mechanisms depends in large part on the ability of the individuals with knowledge to speak candidly and confidentially with lawyers, any attempt to require routine waiver of attorney-client and work product protections will seriously undermine systems that are crucial to compliance and have worked well."³⁹ Such an outcome could undermine the very enforcement objectives that prompted the Thompson Memorandum in the first place.

Further exacerbating the Thompson Memorandum's culture of waiver is the courts' unwillingness to adopt the notion of selective or limited waiver. Corporations providing information covered by the attorney-client privilege and/or work product protection to prosecutors and regulators have argued that these waivers should not permit private litigants freely to obtain protected information produced to the government. With the exception of the Eighth Circuit in *Diversified Industries, Inc. v. Meredith*,⁴⁰ every circuit court that has considered

³² NASD, *Principal Considerations in Determining Sanctions* (2006), available at <http://www.nasd.com/RegulatoryEnforcement/NASDENforcementMarketRegulation/NASDSanctionGuidelines/PrincipalConsiderationsinDeterminingSanctions/index.htm>.

³³ See Larry D. Thompson, Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cfft/corporate_guidelines.htm.

³⁴ Compare Thompson Memorandum, *supra* note 33, with Eric E. Holder, Jr., Deputy Attorney General, Federal Prosecution of Corporations (June 16, 1999), available at <http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html>.

³⁵ See, e.g., *The Thompson Memorandum's Effect on the Right to Counsel in Corporate Investigations: Hearing Before the United States Senate Committee on the Judiciary*, 109th Cong. (Sept. 12, 2006) [hereinafter *Senate Hearings*]; *Memo to Gonzales*, WALL ST. J., Sept. 8, 2006, at A14; John Hasnas, *Department of Coercion*, WALL ST. J., Mar. 11, 2006; *White Collar Enforcement (Part I): Attorney-Client Privilege and Corporate Waivers: Hearing Before the Subcommittee on Crime, Terrorism & Homeland Security of the H. Comm. On the Judiciary*, 109th Cong. (Mar. 7, 2006) [hereinafter *House Hearings*].

³⁶ *Senate Hearings*, *supra* note 35 (testimony of Edwin Meese III).

³⁷ The DOJ has denied that consideration of these factors was mandatory under the Thompson Memorandum, notwithstanding their description as mandatory in the Criminal Resource Manual. Compare *Senate Hearings*, *supra* note 35 (testimony of Paul J. McNulty, Deputy Attorney General), with U.S. Department of Justice, Criminal Resource Manual § 163 (Oct. 21, 2005).

³⁸ *Senate Hearings*, *supra* note 35 (testimony of Edwin Meese III).

³⁹ *Id.* (testimony of Karen J. Mathis).

⁴⁰ 572 F.2d 596, 611 (8th Cir. 1977) (en banc).

the question of selective or limited waiver of the attorney-client privilege has rejected it.⁴¹ Similarly, only the Fourth Circuit has adopted the notion of selective or limited waiver of work product protection.⁴² The First, Third, Sixth, Eighth, and Tenth Circuits have all rejected a selective or limited waiver rule for work product protected information.⁴³ Some circuits have left open the possibility of recognizing the selective or limited waiver rule for work product protected information in limited circumstances.⁴⁴ While in some jurisdictions a confidentiality agreement might go some way to protect privileged information,⁴⁵ at least three circuits have held that the disclosure of privileged information operates as a waiver notwithstanding the existence of a confidentiality agreement.⁴⁶

The McNulty Memorandum

In recent months, efforts to temper the Thompson Memorandum policies have gained momentum. Four

developments are of particular note: (i) the DOJ's new internal guidance, the McNulty Memorandum; (ii) the Financial Services Regulatory Relief Act; (iii) the proposed Federal Rule of Evidence 502; and (iv) proposed Attorney-Client Privilege Protection Act of 2007. We deal with the McNulty Memorandum first.

On December 12, 2006, in response to the growing criticism of the Thompson Memorandum and the supplemental memorandum by Acting Deputy Attorney General Robert McCallum (the "McCallum Memorandum"),⁴⁷ Deputy Attorney General Paul J. McNulty released the McNulty Memorandum.⁴⁸ The McNulty Memorandum makes two key changes to the Thompson Memorandum's principles. First, it limits the circumstances under which prosecutors may seek waivers of privilege, and provides a procedure for seeking waivers. Second, it takes the position that generally, prosecutors should not take into account whether a corporation is advancing attorneys' fees to its employees or agents under investigation and indictment. The McNulty Memorandum, on the other hand, did not change the Thompson Memorandum's policy regarding the use of joint defense agreements and the willingness of a corporation to sanction employees for misconduct in assessing the extent and value of a corporation's cooperation in a prosecutor's charging decision.

The McNulty Memorandum allows prosecutors to request waivers only if there is a "legitimate need" for the waiver. It sets forth a balancing test for determining whether that need exists. If, after applying the test, a prosecutor determines that there is a "legitimate need," the McNulty Memorandum sets forth a tiered approach to seeking waivers, and requires different levels of authorization based upon the type of information sought.

In determining whether there is a "legitimate need" for privileged information, a prosecutor should consider: (i) the likelihood and degree to which the privileged

⁴¹ *In re Qwest Communications Int'l, Inc.*, 450 F.3d 1179, 1200 (10th Cir. 2006), cert. denied, 127 S. Ct. 584 (2006); *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289, 302 (6th Cir. 2002); *United States v. Massachusetts Inst. of Tech.*, 129 F.3d 681, 686 (1st Cir. 1997); *Westinghouse Elec. Corp. v. Republic of the Phil.*, 951 F.2d 1414, 1425 (3d Cir. 1991); *In re Martin Marietta Corp.*, 856 F.2d 619, 623-24 (4th Cir. 1988); *In re John Doe Corp.*, 675 F.2d 482, 489 (2d Cir. 1982); *Permian Corp. v. United States*, 665 F.2d 1214, 1219-20 (D.C. Cir. 1981).

⁴² See *Martin Marietta*, supra note 41, 856 F.2d at 623, 626 (selective waiver for opinion work product but not for non-opinion work product).

⁴³ See *Qwest*, supra note 41, 450 F.3d at 1192; *In re Chrysler Motors Corp. Overnight Evaluation Program Litig.*, 860 F.2d 844, 846-47 (8th Cir. 1988); *Massachusetts Inst. of Tech.*, supra note 40, 129 F.3d at 687; *Westinghouse*, 951 F.2d at 1429; *Columbia/HCA Healthcare*, supra note 41, 293 F.3d at 306-307.

⁴⁴ See, e.g., *In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1372-75 (D.C. Cir. 1984); *In re Steinhardt Partners*, 9 F.3d 230, 236 (2d Cir. 1993).

⁴⁵ See, e.g., *Steinhardt Partners*, supra note 44, 9 F.3d at 236; *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, No. 02 C 5893, 2006 WL 3524016, at *20-*22 (N.D. Ill. Dec. 6, 2006); *In re Natural Gas Commodity Litig.*, No. 03 Civ. 6186VMAJP, 2005 WL 1457666, at *9 (S.D.N.Y. June 21, 2005).

⁴⁶ See *Qwest*, supra note 41, 450 F.3d at 1194; *Columbia/HCA Healthcare Corp.* supra note 41, 293 F.3d at 307; *Chrysler Motors Corp.*, supra note 42, 860 F.2d at 847.

⁴⁷ See Memorandum from Acting Deputy Attorney General Robert McCallum, *Waiver of Corporate Attorney-Client and Work Product Protection* (Oct. 21, 2005).

⁴⁸ See Paul J. McNulty, Deputy Attorney General, *Principles of Federal Prosecution of Business Organizations* (Dec. 12, 2006), available at http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf, at 1-2 (discussing role of public criticism of Thompson Memorandum in issuing new guidance); Carrie Johnson, *Shift in Corporate Prosecution Ahead: Government to Stiffen Rules on Indicting Companies*, WASH. POST, Nov. 30, 2006, at D1.

information will benefit the government's investigation; (ii) whether the information sought can be obtained in a timely and complete fashion by using alternative means that do not require waiver; (iii) the completeness of the voluntary disclosure already provided; and (iv) the collateral consequences to a corporation of a waiver.⁴⁹

A "legitimate need for the information is not established by concluding it is merely desirable or convenient to obtain privileged information." Other than listing this vague four-part test, and cautioning that a prosecutor may not engage in perfunctory testing, the McNulty Memorandum does not explain how a prosecutor is to use the four-part test to decide whether a "legitimate need" exists for demanding protected information. It is the rare accounting fraud or other complex securities law investigation that will fail the four-part "legitimate need" test.

If a "legitimate need" exists after a "careful balancing" under the four-part test, the McNulty Memorandum counsels prosecutors to "seek the least intrusive waiver necessary to conduct a complete and thorough investigation," and provides a tiered approach to requesting waiver. Prosecutors are instructed that they should request Category I information first. Category I information is "purely factual information, which may or may not be privileged, relating to the underlying misconduct." Category I information, according to the McNulty Memorandum, includes material such as "copies of key documents, witness statements, or purely factual interview memoranda regarding the underlying misconduct, organization charts created by company counsel, factual chronologies, factual summaries, or reports . . . containing investigative facts documented by counsel." Failure to produce Category I information when requested can – and most likely will – be considered "in determining whether a corporation has cooperated in the government's investigation."

Before requesting waiver of Category I information, a prosecutor must obtain written authorization from the United States Attorney, who "must provide a copy of the request to, and consult with, the Assistant Attorney General for the Criminal Division before granting or denying the request." The prosecutor's request for authorization to the United States Attorney must set forth the "legitimate need" and the scope of the waiver sought, and the United States Attorney is required to maintain both the request for authorization and the authorization itself. The United States Attorney must

communicate any authorized request for waiver in writing to the corporation.

Prosecutors are permitted to seek Category II information – defined as "attorney-client communications or non-factual attorney work product," including legal advice given to the corporation before, during and after the underlying misconduct occurred – only if Category I information provides "an incomplete basis to conduct a thorough investigation." The McNulty Memorandum cautions prosecutors to seek Category II information – which may include attorney notes, memoranda containing counsel's mental impressions and conclusion, or legal determinations reached as a result of an internal investigation – in "rare circumstances." Unlike with Category I information, a prosecutor must not consider a corporation's refusal to provide a waiver for Category II information in making charging decisions. Nevertheless, "[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."

Before requesting Category II information, the United States Attorney must request authorization, in writing, from the Deputy Attorney General, setting forth the "legitimate need" and the scope of the waiver sought. Any approval must be in writing. If authorized to request Category II information, the United States Attorney must communicate the request in writing to the corporation.

The McNulty Memorandum carves out an exception to this procedure for two types of Category II information: (i) legal advice given at the time of the underlying misconduct, when the corporation or one of its employees is relying upon an advice-of-counsel defense; and (ii) legal advice or communications coming within the crime-fraud exception to the attorney-client privilege. Requests for these types of Category II information do not need the approval of the Deputy Attorney General, and may be obtained under the authorization process for Category I information.

Finally, the McNulty Memorandum notes that federal prosecutors are not required to obtain authorization "if the corporation voluntarily offers privileged documents without a request by the government." Voluntary waivers must be reported to the United States Attorney or the Assistant Attorney General in the Division where the case originated, and that office must maintain a record of these reports.

⁴⁹ McNulty Memorandum, *supra* note 48, § VII.B.2.

It is difficult to see how the new waiver framework, which seemingly favors form over substance, addresses the fundamental concerns that prompted calls for revisions to the Thompson Memorandum. Nor does the McNulty Memorandum address the issue of selective or limited waiver. Moreover, the McNulty Memorandum draws a hollow distinction between treating companies that waive their privilege “favorably” and not holding refusal “against” companies that elect not to waive their privilege. Especially in light of prosecutors’ use of previously settled cases when negotiating additional settlements, this dubious distinction does nothing to advance the debate. No corporation in America today is going to take the risk of leaving the extra points that it can get from cooperation on the table, assuming that prosecutors will not hold that against it when the time comes to make charging decisions. How could a corporation justify to its shareholders a refusal to waive privilege when, in its shareholders’ eyes, a waiver might have helped the corporation to avoid indictment and all but certain extinction?

Early reaction to the McNulty Memorandum questions whether these new procedures meaningfully address the criticisms of the Thompson Memorandum. In the ABA’s view, the McNulty Memorandum “merely requires high level Department approval before waiver requests can be made. As such, [it] threatens to further erode the ability of corporate leaders to seek and obtain the legal guidance they need to effectively comply with the law.”⁵⁰ The bottom line is that prosecutors can still lean on corporations to produce Category I and II privileged information, while dangling cooperation credit as an incentive. It also remains to be seen how stringently the United States Attorneys across the country will apply the “legitimate need” and “an incomplete basis to conduct a thorough investigation” tests.

In addition to its discussion of the waiver rule, the McNulty Memorandum addresses the question of a corporation’s advancing attorneys’ fees to its employees and agents. In a tacit effort to address a pair of decisions handed down in June and July 2006 by Judge Lewis Kaplan in the KPMG tax shelter cases, the McNulty Memorandum changed the Thompson Memorandum to counsel prosecutors not to “take into account whether a

corporation is advancing attorneys’ fees to employees or agents under investigation and indictment.”⁵¹ This revision should give corporations more comfort to advance legal fees to current and or former employees without wondering whether the government will view advancement of legal fees as a failure to cooperate.⁵²

Corporations should, however, be aware that in “extremely rare cases, the advancement of legal fees may be taken into account when the totality of the circumstances show that it was intended to impede a criminal investigation.”⁵³ The McNulty Memorandum counsels that when such circumstances exist, “fee advancement is considered with many other telling facts to make a determination that the corporation is acting improperly to shield itself and its culpable employees from government scrutiny.” This view is apparently an attempt to echo the government’s position on an appeal of Judge Kaplan’s suppression order in *Stein I*, currently pending before the Second Circuit, in which the government argues that its consideration of the advancement of attorneys’ fees is limited to these narrow circumstances.⁵⁴ Where the “extremely rare case” exists, a prosecutor must obtain approval from the Deputy Attorney General (in accordance with the procedure for requesting waivers with respect to Category II information) before considering this factor in the charging decision.⁵⁵

The McNulty Memorandum did not change the Thompson Memorandum as it relates to the use of joint defense agreements and employee sanctions. It still views the use of a joint defense agreement and the failure to sanction employees engaged in wrongful conduct as probative of whether a corporation is shielding its culpable employees and agents from a government investigation.⁵⁶ The ABA has criticized the decision to retain these two policy considerations, arguing that the McNulty Memorandum “does not fully protect employees’ legal rights in that it continues to allow prosecutors to force companies to take punitive

⁵⁰ Press Release, Statement by ABA President Karen J. Mathis Regarding Revisions to the Justice Department’s Thompson Memorandum (Dec. 12, 2006), available at <http://www.abanet.org/abanet/media/statement/statement.cfm?releaseid=59> [hereinafter ABA Press Release].

⁵¹ McNulty Memorandum, *supra* note 48, §VII.B.3.

⁵² For a detailed discussion of the *Stein* decisions’ influence on the SEC and DOJ policies of compelled waiver, see David Z. Seide, *Compelled Waivers of the Attorney-Client Privilege*, 39-21 REV. SEC. & COMMOD. REG. 235 (2006).

⁵³ McNulty Memorandum, *supra* note 48, §VII.B.3 n.3.

⁵⁴ Brief for Appellant at 43, 47-56, *United States v. Smith and Watson*, No. 06-3999-cr (2d Cir. Nov. 6, 2006).

⁵⁵ McNulty Memorandum, *supra* note 48, §VII.B.3 n.3.

⁵⁶ *Id.* § VII.B.3.

actions against their employees in some cases in return for cooperation credit, long before any guilty is established.”⁵⁷

THE OTHER RESPONSES

Financial Services Regulatory Relief Act

Amending the Federal Deposit Insurance Act and the Federal Credit Union Act, the Financial Services Regulatory Relief Act of 2006 provides that an insured depository institution or credit union does not waive its privileges in connection with a disclosure made to federal, state, or foreign banking authority during a supervisory or regulatory process of that authority.⁵⁸ At least as it relates to depository institutions and credit unions, these new provisions, effective October 13, 2006, should provide some protection in shielding privileged information from private third-party litigants who typically seek to use privileged information to shore up their private lawsuits. It remains to be seen how courts will respond to this new tool in the arsenal of depository institutions and credit unions.

Proposed Amendment to the Federal Rules of Evidence: Rule 502

In an effort to address the culture of waiver occasioned primarily by the Thompson Memorandum and the SEC’s Seaboard Report, the Advisory Committee on Evidence Rules released for public comment proposed Federal Rule of Evidence 502.⁵⁹ If passed by Congress, proposed Rule 502(c), like the

Financial Services Regulatory Relief Act of 2006, would permit corporations to produce protected information to government agencies without rendering otherwise privileged documents, information, and advice discoverable by future civil litigants.⁶⁰

Even though Rule 502(c) would limit access to materials disclosed to government authorities in follow-on civil litigation, it is important to note that in an environment in which enforcement agencies value waiver as an indicator of a corporation’s willingness to cooperate, the availability of selective waiver may contribute to the perception that prosecutors and other enforcement agents are entitled to corporate waivers of privileges as a matter of course, since a big obstacle to waiver would have been removed. Although passage of legislation such as that proposed by Senator Specter (discussed below) would temper this effect, it may continue to chill candor between employees and the corporation’s lawyers – one of the very policies behind the attorney-client privilege.⁶¹

Attorney-Client Privilege Protection Act of 2007

Against the backdrop of criticism to the Thompson Memorandum, and in spite of the McNulty Memorandum, on January 4, 2007, Senator Arlen Specter reintroduced the Attorney-Client Privilege Protection Act of 2007, proposed legislation that is designed to bar three DOJ policies encouraged by the Thompson Memorandum.⁶² First, federal enforcement agents and attorneys would be barred from demanding, requesting, or conditioning treatment on “the disclosure by an organization, or person affiliated with that organization, of any communication protected by the attorney-client privilege or any attorney work product.” Second, federal enforcement agents and attorneys would not be permitted to condition charging decisions on the

⁵⁷ ABA Press Release, *supra* note 50. For an additional discussion of the limited impact of the McNulty Memorandum, see generally Richard Ben-Veniste & Raj De, *The “McNulty Memo”: A Missed Opportunity to Reverse Erosion of Attorney-Client Privilege*, LEGAL BACKGROUNDER, Washington Legal Foundation, Vol. 22, No. 3 (Jan. 19, 2007) (“Speculation now centers on whether the McNulty Memo will forestall, or at least delay, legislative action on the expected DOJ argument that until the impact of this new policy guidance can be gauged, it would be premature for Congress to act.”).

⁵⁸ Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, Sec. 607, 120 Stat. 1966 (2006), codified at 12 U.S.C. § 1828(x) (depository institutions) and 12 U.S.C. § 1785(j) (credit unions).

⁵⁹ See Report of the Advisory Committee on Evidence Rules, Proposed Amendment to the Federal Rules of Evidence, FED. R. EVID. 502(c), at 12, *available at* www.uscourts.gov/rules/Excerpt_EV_Report_Pub.pdf (revised June 30, 2006). The proposed rule must be enacted directly by Congress, because it is a rule affecting privileges that seeks to bind state courts.

⁶⁰ Public hearings on proposed Rule 502 were held in Phoenix and New York in January 2007, and the public comment deadline was February 15, 2007. See Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Memorandum to the Bench, Bar, and Public on Proposed Amendments to the Federal Rules (Aug. 10, 2006), *available at* http://www.uscourts.gov/rules/Memo_Bench_Bar_and_Public_2006.pdf.

⁶¹ See John Gibeaut, *Waiving Goodbye? Businesses, Corporate Counsel Are Wary About Selective Waiver Proposal*, ABA JOURNAL vol. 92, Oct. 2006, at 16-18.

⁶² See Attorney-Client Privilege Protection Act of 2007, S. 186, 110th Cong. 1st Sess. (2007). Senator Specter reintroduced this legislation, which he had originally submitted during the 109th Congress in December 2006.

waiver of valid assertions of attorney-client privilege or work product protection, an organization's declining to advance an employee's legal fees, or the relinquishing of its right to enter into a joint defense agreement. Third, the proposed legislation would prohibit federal enforcement agents and attorneys from using claims of attorney-client privilege or work product protection, the advancement of attorneys' fees, or entry into joint defense agreements as factors in determining whether the organization is cooperating with the government. Under the proposed legislation, a corporation is not prohibited from making, or a federal enforcement agent or attorney is not precluded from accepting, a voluntary and unsolicited offer to share the internal investigation materials of such an organization.

Currently, Senator Specter's proposed legislation is before the Senate Committee on the Judiciary.⁶³ Although promising, it is too early to tell whether it will ever become law.⁶⁴ It does, however, send a clear message to federal regulators that the tactics outlined in the Thompson Memorandum and the superseding McNulty Memorandum have outlived their usefulness and that the time has come to review their continuing use.⁶⁵

DOES COOPERATION REALLY PAY?

In response to the demands described above by federal prosecutors, enforcement agencies and self regulatory organizations, many corporations now go to great lengths to take whatever steps they believe are necessary to help avoid criminal indictment and minimize civil penalties. Corporations have, among other things, waived privileges, required employees to make themselves accessible to enforcement agencies, provided results of internal investigations and

interviews, declined to pay attorneys' fees, and revamped their internal compliance programs.⁶⁶

Recent SEC settlements indicate that the SEC is serious about rewarding cooperation. For example, in October 2006, the Commission issued a cease-and-desist order against Statoil, ASA, a Norwegian corporation that issues American Depositary Shares registered pursuant to Section 12(b) of the Exchange Act.⁶⁷ In so doing, the Commission considered Statoil's remedial actions and cooperation with the Commission. Statoil allegedly had violated the antibribery provisions of the Foreign Corrupt Practices Act ("FCPA") by bribing an Iranian government official to help Statoil obtain a contract to develop an oil and gas field in Iran. Statoil also allegedly violated the books and records and internal controls provisions of the FCPA by failing properly to account for the illegal payments and accurately to describe the contract in its books and records. In its release, the Commission extensively described Statoil's cooperation.⁶⁸ Although the Commission ordered

⁶³ See Attorney-Client Privilege Protection Act of 2007, *supra* note 62, status available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d110:SN00186:@@L&summ2=m&>.

⁶⁴ See Sen. Specter Continues Efforts to Force DOJ to Stop Seeking Corporate Waiver of Privilege, BNA WHITE COLLAR CRIME REPORT, Vol. 1, No. 26, at 827 (Jan. 19, 2007) (noting that Sen. Patrick Leahy "plans to give DOJ a chance to implement the new policy before deciding whether to move ahead with the legislation").

⁶⁵ See also 153 Cong. Rec. S42-01, at S181-183 (Jan. 4, 2007) (statement of Sen. Specter). When reintroducing this legislation to the 110th Congress, Specter observed that "[t]here is no need to wait to see how the McNulty memorandum will operate in practice. The flaws in that memorandum are already apparent."

⁶⁶ See generally, e.g., *United States v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006) (chronicling the numerous actions taken by KPMG in its efforts to avoid indictment); see also the deferred prosecution agreements in *United States v. Computer Associates Int'l*, Cr. No. 04-837 (ILG) (E.D.N.Y. Sept. 24, 2004); *United States v. AIG-FP Pagic Equity Holding Corp.* (W.D. Pa. Nov. 30, 2004); *United States v. America Online, Inc.*, Crim. No. 1:04 M 1133 (E.D. Va.); Siobhan Hughes, *Prudential Will Pay \$600 Million*, WALL ST. J., Aug. 29, 2006, at C11; Press Release, Justice Department, PNC ICLC Corp. Enters into Deferred Prosecution Agreement with the United States (June 2, 2003), available at http://www.usdoj.gov/opa/pr/2003/June/03_crm_329.htm; Press Release, Justice Department, 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; Press Release, Justice Department, Schnitzer Steel Industries Inc.'s Subsidiary Pleads Guilty to Foreign Bribes and Agrees to Pay a \$7.5 Million Criminal Fine (Oct. 16, 2006), available at http://www.usdoj.gov/criminal/press_room/press_releases/2006_4809_10-16-06schnitzerfraud.pdf.

⁶⁷ *In the Matter of Statoil, ASA*, Rel. 34-54599, 2006 WL 2933839, at *1-*2 (Oct. 13, 2006).

⁶⁸ The Commission described Statoil's cooperation as follows:

Since [being informed of the SEC's inquiry], Statoil has cooperated with the staff's investigation, producing all documents and information that the staff requested, including voluntary production of documents protected by the attorney-client privilege pursuant to a non-waiver agreement and early production and identification to the staff of relevant documents. Statoil also agreed to make employees available for interviews and encouraged employee cooperation by agreeing to pay travel expenses and attorney's fees. Statoil's Board of Directors has

Statoil to cease and desist from further violations of the Exchange Act, to comply with a number of undertakings, and to pay disgorgement of \$10.5 million, the Commission did not seek civil monetary penalties.⁶⁹

In April 2006, the Commission ordered Oil States International, Inc. to cease and desist from future violations of the federal securities laws. It did not, however, seek monetary penalties because Oil States International was proactive in discovering the securities laws violations, conducting an internal investigation, voluntarily reporting their findings to the Commission and the Justice Department, and cooperating fully with the SEC's investigation.⁷⁰

In another April 2006 release, the SEC announced that it would not bring an enforcement action against either MetLife or its subsidiary, New England Financial ("NEF"), based on charges that three former officers of NEF engaged in a fraudulent and improper reclassification of over \$100 million in NEF expenses, directly resulting in MetLife and NEF disclosing materially false overstatements of net income in

financial statements filed with the Commission.⁷¹ Although the SEC filed civil fraud actions against the individual executives, it chose not to bring an enforcement action against MetLife or NEF "because of MetLife's extensive cooperation in the Commission's investigation of the improper reclassifications that are the subject of the Commission's complaint."⁷²

Since the Seaboard Report, the SEC has not only rewarded cooperation; it has also punished companies for inadequate cooperation. For example, in May 2004, the Commission announced that Lucent Technologies Inc. had settled with the SEC charges that Lucent had engaged in accounting fraud, in a statement that explicitly emphasized the respondent's failure to cooperate in SEC investigations.⁷³ Part of the settlement agreement required Lucent to pay a \$25 million penalty due to its failure to cooperate during the course of the SEC's investigation. The Commission's press release detailed Lucent's failures that contributed to this penalty, including: (i) providing incomplete and untimely document production, and failing to ensure that a relevant document was preserved, which impeded the SEC's ability to conduct its investigation; (ii) after reaching an agreement in principle with the SEC to settle the case, Lucent's former chairman/CEO, in an interview with Fortune magazine, made statements that, in the SEC's view, amounted to a denial that an accounting fraud had occurred, and therefore "undermined both the spirit and letter of its agreement in principle with the staff"; (iii) after reaching its agreement in principle to settle the case, "Lucent expanded the scope of employees that could be indemnified against the consequences of the Commission's enforcement action," which the SEC viewed as contrary to public interest; and (iv) Lucent failed to provide timely and full disclosure to the SEC staff on "a key issue concerning indemnification of employees." Since the Lucent settlement, the Commission has cited lack of cooperation as the basis

footnote continued from previous page...

taken remedial actions, including retaining outside counsel to conduct an investigation of the Contract, and a separate investigation into other non-Norwegian contracts, the results of which were provided to the staff. Statoil has also designed and is implementing a remedial plan, which includes (i) the creation of a corporate compliance officer and ethics committees, (ii) expanded roles for Statoil's Audit Committee to oversee compliance with the FCPA and other applicable foreign bribery laws, (iii) new reporting lines directly to the Audit Committee and Board of Directors, (iv) new ethics, procurement, and due diligence policies, (v) enhanced programs for educating and training executives and employees on ethical matters, including FCPA/anti-bribery compliance training, and (vi) an ethical help-line operated by a third party, which provides anonymity for callers.

Id. at *5.

⁶⁹ *Id.* at *10. The Department of Justice did, however, impose a \$10.5 million financial penalty against Statoil, and required it to enter into a three-year deferred prosecution agreement, in a parallel criminal investigation. See Press Release, U.S. Attorney, S.D.N.Y., U.S. Resolves Probe Against Oil Company that Bribe Iranian Official (Oct. 13, 2006), available at <http://www.usdoj.gov/usao/nys/pressreleases/October06/statoildeferredprosecutionagreementpr.pdf>.

⁷⁰ *In the Matter of Oil States Int'l, Inc.*, Rel. No. 34-53732, 2006 WL 1113519, at *1-*4 (Apr. 27, 2006).

⁷¹ *SEC v. Faria*, Lit. Rel. No. 19656 (Apr. 13, 2006), 2006 WL 985304, at *1-*2.

⁷² *Id.* at *2. According to the Release, "MetLife's cooperation consisted of prompt self-reporting, an independent internal investigation, sharing the results of that investigation with the government, disciplining responsible wrongdoers, and implementing new controls designed to prevent the recurrence of the improper conduct."

⁷³ Press Release, SEC, Lucent Settles SEC Enforcement Action Charging the Company with \$1.1 Billion Accounting Fraud (May 17, 2004), available at <http://www.sec.gov/news/press/2004-67.htm>.

for imposing relatively large civil penalties in other enforcement actions.⁷⁴

Cooperation has also helped many corporations avoid indictment, and has helped them to obtain deferred and non-prosecution agreements.⁷⁵ The Justice Department's increased use of these agreements follows the very public demise of Arthur Andersen LLP in June 2002, after which Andersen was convicted for obstruction of justice because it destroyed documents relating to its Enron audit.⁷⁶ Among the many notable aspects of the Andersen investigation, indictment, and trial was Andersen's failure to reach agreement with the Justice Department on the terms of a deferred prosecution agreement that could have averted a

criminal trial.⁷⁷ Since the Andersen case, numerous companies have entered into deferred prosecution agreements; others have entered into non-prosecution agreements.⁷⁸ In press releases and news reports, the Justice Department often points to a corporation's cooperation as the basis for reaching deferred or non-prosecution agreements.

In a typical deferred prosecution agreement, the government files a criminal complaint against the corporation, and the corporation accepts responsibility for the conduct. Based on the corporation's acceptance of responsibility, and as long as the corporation complies with all of the obligations set forth in the deferred prosecution agreement – which can include, *inter alia*, the payment of fines and penalties, extensive cooperation with the Justice Department's investigation, appointment of an independent monitor, establishment of internal compliance programs, and waiver of the attorney-client and work product protections – the government defers prosecution (often for between twelve and twenty-four months). At the end of the deferral period, if the corporation has complied with its obligation under the agreement, the complaint is dismissed with prejudice.⁷⁹ A typical non-prosecution agreement imposes similar obligations on the corporation, and places the corporation on probation; if the corporation fails to comply with the obligations of the non-prosecution agreement, it can be prosecuted.⁸⁰

The DOJ's recent investigation of KPMG and some of its employees in connection with abusive tax shelters highlights the lengths to which companies will go to avoid indictment. Allegedly under intense pressure from the Justice Department, KPMG cut off payment of attorneys' fees for one of its former senior partners who

⁷⁴ See, e.g., Press Release 2006-104, SEC, SEC Settles with Raytheon Company, Former CEO, and Subsidiary Controller for Improper Disclosure and Accounting Practices, 2006 WL 1757210 (June 28, 2006) (Raytheon agreed to \$12 million civil penalty); *SEC v. CIBC Mellon Trust Co.*, Lit. Rel. No. 19081, 2005 WL 372505, at *1 (Feb. 16, 2005) (\$5 million); Press Release 2004-152, SEC, SEC Charges Wachovia Corp. with Proxy Disclosure and Other Reporting Violations Involving the 2001 Merger Between First Union Corp. and Old Wachovia Corp., 2004 WL 2477212 (Nov. 4, 2004) (\$37 million); *SEC v. Gemstar-TV Guide Int'l, Inc.*, Lit. Rel. No. 18760, 2004 WL 1404277, at *1-*2 (June 23, 2004) (\$10 million); *SEC v. Symbol Technologies, Inc.*, Lit. Rel. No. 18734, 2004 WL 1217620, at *2-*3 (June 3, 2004) (\$37 million).

⁷⁵ See *supra* note 66 (deferred prosecution agreements); see also, e.g., Press Release, U.S. Attorney, S.D.N.Y., U.S. Reaches Non-Prosecution Agreement With Royal Ahold, N.V. (Sept. 28, 2006); Press Release, U.S. Attorney, N.D. AL., Statement of U.S. Attorney Alice H. Martin Regarding Non-Prosecution Agreement Reached with HealthSouth Corporation (May 18, 2006); Press Release, U.S. Attorney, E.D.N.Y., The Bank of New York Resolves Parallel Criminal Investigations Through Non-prosecution Agreement with the United States: Agrees to Pay \$38 Million in Penalties and Victim Compensation (Nov. 8, 2005); Press Release, U.S. Attorney, S.D.N.Y., Adelphia Communications Agrees to Pay \$715 Million to Government Victim Compensation Fund (Apr. 25, 2004); Laurie P. Cohen, *Deferred Deals Like Quattrone's Are on the Rise*, WALL ST. J., Aug. 24, 2006, at C1 (reporting that prosecutors entered into 23 deferred and non-prosecution agreements with major U.S. companies between 2002 and 2005, compared with 11 such agreements between 1992 and 2001).

⁷⁶ See Press Release 2002-89, SEC Statement Regarding Andersen Case Conviction (June 15, 2002), available at <http://www.sec.gov/news/press/2002-89.htm> (noting that due to the jury's verdict convicting Arthur Andersen of obstruction of justice, the auditing firm would "cease practicing before the Commission by Aug. 31, 2002, unless the Commission determines another date is appropriate").

⁷⁷ See Jonathan D. Glater, *Government Rejects Andersen Proposal*, N.Y. TIMES, Apr. 26, 2002, at C6; see also Kurt Eichenwald and Jonathan D. Glater, *Andersen Sends New Proposal for Settlement to Government*, N.Y. TIMES, Apr. 25, 2002, at C1. According to the *Times*, the government had proposed a deferred prosecution agreement, but had, in the view of Andersen's lawyers, given Andersen too little time to assess the proposed deal. Eichenwald and Glater, *supra*, at C1. After prosecutors ended negotiation, Andersen provided a new proposal, which purportedly contained "as much as 90%" of the government's proposed agreement. *Id.* The government rejected this new proposal. Glater, *supra*, at C6.

⁷⁸ See *supra* notes 66, 75.

⁷⁹ See, e.g., *supra* note 66.

⁸⁰ See, e.g., HealthSouth Corporation Non-Prosecution Agreement with U.S. Attorney, N.D. AL., (May 17, 2006), available at www.usdoj.gov/usao/aln/Docs/May%202006/healthsouthnonpros2.pdf.

had received a severance package that included those fees.⁸¹ KPMG also conditioned the payment of legal fees to certain other employees on their full cooperation with the government investigation – something which KPMG’s lawyers viewed as “never heard of before,” and as exhibiting “a level of cooperation that is rarely done.”⁸² On August 29, 2005, KPMG entered into a deferred prosecution agreement in which it agreed to, *inter alia*, be charged in a one-count information, admit extensive wrongdoing, pay a \$465 million fine, and accept restrictions on its practice. The government, in turn, agreed to seek dismissal of the information as long as KPMG complied with its obligations. At about the same time, the government indicted certain former KPMG employees, and KPMG stopped paying their legal fees and expenses.⁸³

CONCLUSION

As the foregoing discussion demonstrates, a “carrot and stick” approach to the role of cooperation is pervasive in the current enforcement environment, with government agencies rewarding those who cooperate, and punishing those who do not. Although cooperation unquestionably may yield many benefits, including avoiding prosecution and minimizing penalties, lawyers for corporations and other business organizations should proceed carefully. Indeed, lawyers must be aware that significant problems may result from yielding to the government’s every demand during the course of an investigation. In the next issue of *The Review*, Part II of this article will explore the numerous pitfalls to consider when cooperating with government enforcement agencies. ■

⁸¹ *United States v. Stein*, 435 F. Supp. 2d 330, 339, 348 (S.D.N.Y. 2006).

⁸² *Id.* at 349.

⁸³ *Id.* at 350.

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