

Chapter 2

The New Role of Corporate Internal Investigations

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§ 2:1 Introduction

Until recently, federal enforcement agencies and regulators had been largely content to take a reactive approach to white collar crime and regulatory actions, meting out sanctions after discovering violations.¹ Now, in the wake of numerous high-profile criminal prosecutions and civil enforcement actions, federal regulators and enforcement agencies have become more proactive in seeking out evidence of corporate misconduct. In turn, they have demanded that corporations become more aggressive in identifying and self-reporting illegal conduct. Regulators have largely done so by instituting and formalizing a clear carrot-and-stick approach to corporate internal investigations—promising lighter punishments for companies that cooperate by conducting thorough investigations at the first sign of trouble and fully disclose the results of those investigations to the government, and threatening harsh penalties for companies that fail on either count. The worst of these penalties, as the recent past has made clear, can result in substantial civil and criminal penalties for corporate executives and even the demise of the target corporation.

Under this new enforcement regime, cooperation efforts that begin only when the government arrives on the scene are often deemed insufficient to head off the harshest of these civil and criminal sanctions. Accordingly, corporate counsel face substantial pressure to conduct investigations that begin earlier, dig deeper, and disclose more broadly than ever before. The inevitable result is that the corporate internal investigation is tied more tightly than ever to both corporate punishment and corporate survival. The disclosures mandated by the new enforcement regime will often ensure the imposition of some sanctions, but the same disclosures, corporate counsel are told, will stave off the worst of those sanctions. Section 2:2, below, describes the recent changes that have reshaped the enforcement environment and, with it, the role of the corporate internal investigation. Section 2:3 details some of the benefits that have accrued to corporations that have successfully responded to this new enforcement environment.

§ 2:2 New Sources of Pressure to Conduct Internal Investigations

Since 2001, a series of legislative and regulatory initiatives has markedly increased incentives to conduct internal investigations when allegations of misconduct surface in corporate America. These

1. *See, e.g.*, Stephen M. Cutler, Remarks Before the District of Columbia Bar Assoc. (Feb. 11, 2004), *available at* www.sec.gov/news/speech/speech021104smc.htm [hereinafter “Cutler Remarks”].

developments include the passage of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”), the issuance of policy statements concerning cooperation by the Department of Justice (DOJ or “Justice Department”) and the Securities and Exchange Commission (SEC or the “Commission”), and follow-on undertakings on the part of the New York Stock Exchange (NYSE or the “Exchange”) and National Association of Securities Dealers (NASD).^{1,1}

§ 2:2.1 The Sarbanes-Oxley Act of 2002

Sarbanes-Oxley² was the principal legislative response to the numerous corporate and accounting scandals occurring between 2000–2002 that diminished public trust in reporting practices. Two of Sarbanes-Oxley’s provisions in particular have helped to reshape the role of the internal investigation: section 404 did so by amending the audit requirements governing public companies, while section 307 and the rules subsequently adopted by the SEC did so by imposing new reporting obligations on inside and outside counsel when evidence or suspicions of illegal activity are reported to corporate counsel.³

[A] Section 404

Under section 404 of Sarbanes-Oxley, a public company audit is no longer limited to the company’s financial statements, but must also encompass an assessment of the sufficiency of the internal accounting controls the company employs to ensure the accuracy of its statements.⁴

1.1. In July 2007, the NYSE and NASD combined to form the Financial Industry Regulatory Authority (“FINRA”). However, FINRA has not issued subsequent guidance on cooperation, and FINRA’s general rules make clear that the separate statements on cooperation previously issued by the NYSE and NASD retain force today. *See FINRA Rules, available at www.finra.org/RulesRegulation/FINRARules/index.htm* (“The FINRA rulebook currently consists of both NASD Rules and certain NYSE Rules that FINRA has incorporated (Incorporated NYSE Rules) . . . In interpreting the rule sets, FINRA will continue to apply the same interpretive materials that NASD and NYSE applied prior to closing. For example, FINRA will consider existing NASD interpretive letters and Notices to Members in applying NASD Rules and the NYSE Rule Interpretations Handbook and Information Memos in applying the Incorporated NYSE Rules.”). In addition, FINRA’s Executive Vice President and Chief of Enforcement, Susan L. Merrill, has publicly emphasized the importance of giving FINRA members credit for cooperation, and has revealed that FINRA is considering issuing a new set of guidelines on cooperation. *See* Bruce M. Bettigole and Aimée D. Latimer-Zayets, FINRA Chief Comments On Issues Relating To Unification Of NASD And NYSE Enforcement, *available at www.mondaq.com/article.asp?articleid=52644*.

2. Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. § 7201 *et seq.*).

3. *See, e.g.*, 15 U.S.C. § 78j-1.

4. *See* 15 U.S.C. § 7262.

In making this assessment, the audit committee must use standards for attestation engagements issued or adopted by the Public Company Accounting Oversight Board (PCAOB).⁵ The committee must give an opinion as to whether the internal control procedures are suitably designed to prevent or detect material misstatements on a timely basis.⁶ Management is required, therefore, to acknowledge its responsibility for maintaining adequate internal controls. Such internal controls may include antifraud programs, as well as a system to provide reasonable assurance that transactions are properly authorized and recorded.⁷ While a material weakness in the controls framework will preclude an unqualified opinion that internal controls are effective, it is still possible for the audit committee to issue an unqualified opinion regarding the company's financial statements.⁸ Significant deficiencies in controls do not necessarily translate into financial misstatements.⁹

Sarbanes-Oxley has thus formalized—and, in fact, federalized—the role that audit committees historically have played in monitoring compliance. This is particularly true where financial and disclosure issues are implicated, as Sarbanes-Oxley requires audit committees to establish procedures for (1) the receipt, retention, and treatment of complaints received regarding accounting, internal accounting controls, or auditing matters, and (2) the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.¹⁰

In addition, audit committees have become the primary overseer for investigations into financial reporting and accounting issues. The audit committee is charged with the oversight and responsibility for all aspects of the investigation, including its initiation, conduct and, ultimately, the decision whether, when, and how to report out to the Commission.¹¹ Indeed, Sarbanes-Oxley all but mandates that the audit committee conduct its own internal investigation.¹² Such an investigation is often necessary to determine whether there has been

5. 15 U.S.C. § 7262. See Donald K. McConnell Jr. & George Y. Banks, *How Sarbanes-Oxley Will Change the Audit Process*, J. ACCOUNTANCY, Sept. 2003, available at www.aicpa.org/pubs/jofa/sep2003/mcconn.htm.

6. *See id.*

7. *See id.*

8. *See id.*

9. *See id.*

10. 15 U.S.C. § 78j-1(m)(4).

11. 15 U.S.C. § 78j-1(b)(3).

12. Michaela Dohoney & Win Minot, *The Financial Restatement Process*, SARBANES-OXLEY COMPLIANCE J., Apr. 19, 2006, available at www.sox.com/news/detail.cfm?articleID=1783.

any misconduct by a company employee and whether financial restatements are required as a result. The decision to conduct an internal investigation will often lead to the hiring of outside counsel.¹³ Thus, the statute requires the audit committee to have authority to engage independent counsel and other advisers as it deems necessary to carry out its duties, and it requires the company to provide appropriate funding (as determined by the audit committee) for payment of compensation to those advisers.¹⁴

[B] Section 307

Section 307 of Sarbanes-Oxley and the SEC rules promulgated thereunder also provide a significant impetus for conducting investigations. They do so by placing the onus on a company's attorneys to initiate internal investigations by reporting their suspicions of possible material violations of law up the corporate ladder to the company's chief legal officer and chief executive officer.¹⁵ Upon receiving such a report, the company's chief legal officer must "cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur."¹⁶ After this inquiry is complete, the chief legal officer must take one of two steps: if he or she believes that no violation has occurred, that determination, and the basis for it, must be presented to the attorney who initially reported the possible violation.¹⁷ The reporting attorney must then decide whether the chief legal officer and CEO "have provided an appropriate response within a reasonable time."¹⁸ If not, the reporting attorney must submit his or her evidence concerning the possible violation

- (i) to the audit committee; or if the company has no audit committee,

13. *See id.*

14. 15 U.S.C. § 78j-1(m)(5)-(6).

15. *See* 17 C.F.R. § 205.3(b)(1) ("If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer . . . or to both the issuer's chief legal officer and its chief executive officer."). Where appropriate, this evidence may also be reported directly to the company's legal compliance committee. *See* 17 C.F.R. § 205.3(c)(1).

16. *See* 17 C.F.R. § 205.3(b)(2). Alternatively, the chief legal officer may refer the matter immediately to the company's legal compliance committee. *See* 17 C.F.R. § 205.3(b)(2).

17. *See id.*

18. *See* 17 C.F.R. § 205.3(b)(3).

- (ii) to the company's outside directors; or if there are no outside directors,
- (iii) to the entire board.¹⁹

These requirements essentially require a company's chief legal officer to initiate a formal investigatory process in response to any allegation of wrongdoing that comes to the attention of any in-house lawyer.

§ 2:2.2 SEC Statements on Cooperation

[A] The Seaboard Report

On October 23, 2001, the SEC issued the Seaboard Report, in which it outlined some of the criteria that it would consider in deciding whether to bring an enforcement action against a company. Critically, the role of the company's self-policing efforts and the degree of its cooperation with law enforcement officials featured prominently in the SEC's discussion.²⁰

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- 19. See 17 C.F.R. § 205.3(b)(3). The reporting attorney may also turn directly to these persons if he or she believes it would be futile to first turn to the chief legal officer and chief executive officer. See 17 C.F.R. § 205.3(b)(4).
 - 20. 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, Exchange Act Rel. No. 44,969 (Oct. 23, 2001), available at www.sec.gov/litigation/investreport/34-44969.htm [hereinafter "Seaboard Report"]. Typically, a section 21(a) (15 U.S.C. § 78u(a)) report provides the Commission with an opportunity to signal its future enforcement posture on an issue without having to allege that the federal securities laws have been violated. The Seaboard Report marked the first time that the Commission used a section 21(a) report of investigation in this manner.

The Seaboard Report outlined in detail the steps taken by Seaboard Corporation, the company that was the subject of the SEC's investigation, 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's audit committee. Subsequently, Seaboard's board of directors authorized the company to engage independent outside counsel to conduct a detailed investigation. Four days later, Seaboard dismissed the former controller who had 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 its financial statements would be restated. *Id.* See *In re* Gisela de Leon-Meredith, Exchange Act Rel. No. 44,970, 2001 WL 1268303 (Oct. 23, 2001). The price of Seaboard's shares did not drop after the announcement or after the restatement was published. See Seaboard Report, *supra*. Furthermore, Seaboard provided the SEC with all relevant information concerning the alleged violations. Specifically, Seaboard produced details of its internal investigation

The Seaboard Report identified four broad factors that influence the SEC's evaluation of a company's cooperation:

1. self-policing prior to the discovery of the misconduct, including the establishment of effective compliance procedures and an appropriate tone with respect to compliance at the top of the organization;
2. self-reporting of misconduct upon discovery, including conducting a thorough review of the nature, extent, origins, and consequences of the misconduct, and prompt, complete, and effective disclosure to the public, regulators, and self-regulatory organizations;
3. remediation, including the dismissal or appropriate discipline of individual wrongdoers, the modification of internal controls and compliance procedures to prevent recurrence, and the compensation of those adversely affected; and
4. cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts.²¹

While making clear that it was not adopting a rule or limiting its enforcement discretion, the Commission indicated that, where a company takes the steps outlined in the Seaboard Report, it may "credit" the company for its remedial efforts in an exercise of its discretion. 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."²²

(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 this conduct, the Commission resolved not to bring an enforcement action against Seaboard. In announcing its settlement with the controller, however, the Commission did state that Seaboard had violated Exchange Act § 13(a) and 13(b)(2).

21. SEC Press Release, SEC Issues Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion (Oct. 23, 2001), *available at* www.sec.gov/news/headlines/prosdiscretion.htm.
22. *See In re Baker Hughes Inc.*, Exchange Act Rel. No. 44,784 (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 the action.

After outlining Seaboard's cooperative conduct during the SEC's investigation, the Seaboard Report also listed thirteen additional criteria that the Commission will consider in deciding whether to recommend enforcement action against a company.²³ These criteria are:

1. the nature of the misconduct;
2. the way in which the misconduct arose;
3. the locus of the misconduct within the organization;
4. the duration of the misconduct;
5. the level of harm inflicted upon investors and other corporate constituencies and whether the company's share price dropped significantly upon its disclosure;
6. the manner in which the misconduct was detected and who uncovered it;
7. the rapidity of the company's post-discovery response;
8. the steps taken by the company upon learning of the misconduct;
9. the processes followed by the company in resolving the issues raised by its discovery;
10. whether the company fully and expeditiously committed to learning the truth;
11. whether the company promptly reported the results of its review to the SEC staff and provided sufficient documentation reflecting its response to the situation;
12. whether there are assurances that the misconduct is unlikely to recur; and
13. whether the company in which the misconduct occurred has undergone a fundamental corporate change such as a merger or bankruptcy reorganization.²⁴

While SEC practitioners may not have been surprised by the criteria outlined in the Seaboard Report, the Commission's willingness to disclose how it plans to make enforcement decisions where companies self-police and cooperate with its investigations was certainly noteworthy. Indeed, in what then-SEC Chairman Harvey Pitt referred to as a new era of "civility and cooperation," perhaps the greatest benefit of the Seaboard Report is that it demystifies the SEC's decision-making

23. See Seaboard Report, *supra* note 20.

24. See *id.*

process.²⁵ Furthermore, the Seaboard Report provides companies facing potential enforcement problems with new confidence to actively seek out the Commission and self-report. Acknowledging as much, then-Director of Enforcement Stephen Cutler said the Commission “will bring in more cases and use fewer resources,” thereby offering “more protection for investors.”²⁶ Thus, in addition to fostering what Chairman Pitt called a new kinder and gentler agency, the SEC’s posture after the Seaboard Report can be viewed as encouraging collaboration between the public and private sectors in promoting and enhancing the securities markets.

[B] Announcement of Principles for Imposing Monetary Penalties

On January 4, 2006, 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, the Commission took the unusual step of issuing a press release announcing the principles that it will consider when determining whether and to what extent such penalties should be imposed (the “Penalties Statement”).²⁷

In his speech announcing the Penalties Statement, Chairman Cox—perhaps mindful that the issue of imposing multi-million penalties against issuers had divided the Commission under his predecessor—emphasized that the Commission had “unanimously” agreed on the

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25. Chairman Harvey Pitt, Remarks Before the AICPA Governing Council (Oct. 22, 2001), *available at* www.sec.gov/news/speech/spch516.htm.
 26. Maureen Milford, *A Kinder Gentler SEC*, NAT’L L.J., Nov. 12, 2001, at A15.
 27. SEC Press Release, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* www.sec.gov/news/press/2006-4.htm [hereinafter “Penalties Statement”]. The Penalties Statement was published 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. *See SEC v. McAfee, Inc.*, Litig. Rel. No. 19,520 (Jan. 4, 2006). 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% for the second quarter of 2002. *See In re Applix, Inc.*, Exchange Act Rel. No. 53,049 (Jan. 4, 2006). Notwithstanding this conduct, the Commission accepted an offer of settlement that did not include the imposition of a monetary penalty on Applix. *Id.*

principles outlined in the statement.²⁸ Chairman Cox further emphasized that it is the Commission's "intention that these principles will establish objective standards that will provide the maximum degree of investor protection."²⁹

The Penalties Statement outlined two principal factors that the Commission will take into account in deciding whether to impose monetary penalties, along with seven other secondary factors.³⁰ The first principal factor is the presence or absence of a direct benefit to the corporation as a result of the violation.³¹ According to the Commission, the "fact that a corporation has received a direct and material benefit from the offense, for example through reduced expenses or increased revenue, weighs in support of the imposition of a [monetary] penalty. Similarly, a monetary penalty would be appropriate if the issuer is in any other way 'unjustly enriched,'"³² or where shareholders have "received an improper benefit as a result of the violation."³³ At the other end of the continuum lie cases in which the affected company's shareholders are the "principal victims of the securities law violation." In the Commission's view, the case for the imposition of a monetary penalty is at its weakest in these circumstances.³⁴

The second principal factor is the degree to which the penalty will recompense or further harm the injured shareholders.³⁵ With respect to this factor, the Commission stated that, notwithstanding that the "imposition of a penalty on the corporation itself carries with it the risk that shareholders who are innocent of the violation will

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

29. *Id.*

30. See generally Penalties Statement, *supra* note 27.

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.* To illustrate this point, SEC Enforcement Director Linda Chatman Thomsen juxtaposed the allegations in the *McAfee* and *Applix* cases. See Linda Chatman Thomsen, Statement Regarding McAfee, Inc. and Applix, Inc. (Jan. 4, 2006), available at www.sec.gov/news/speech/spch010406lct.htm [hereinafter "Thomsen Statement"]. She 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. See *SEC v. McAfee, Inc.*, Litig. Rel. No. 19,520 (Jan. 4, 2006). Conversely, in *Applix*, the company's shareholders did not benefit from the allegedly violative conduct and the Commission did not find any evidence of other direct benefits to Applix. See *In re Applix, Inc.*, Exchange Act Rel. No. 53,049 (Jan. 4, 2006).

35. Penalties Statement, *supra* note 27.

nonetheless bear the burden of the penalty,” in certain cases, it is appropriate to seek and obtain a monetary penalty because the penalty may be “used as a source of funds to recompense the injury suffered by victims of the securities law violations.”³⁶ However, the “likelihood a corporate penalty will unfairly injure investors, the corporation, or third parties weighs against its use as a sanction.”³⁷ 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.³⁸

Leaning heavily on the Commission’s statutory authority to seek monetary penalties (and the accompanying legislative history), the Penalties Statement outlined seven other factors that will influence its decision to impose monetary penalties in settled enforcement actions. Included among these secondary factors are two that bear directly on the corporate impetus to conduct internal investigations.³⁹ First, echoing 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.⁴⁰ 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.”⁴¹ Where an issuer promptly takes the remedial steps outlined in the Seaboard Report, the Commission will likely decline to impose a monetary penalty.⁴² Conversely “failure of management to take

36. *Id.*

37. *Id.*

38. *Id.*

39. The other five secondary factors identified by the Commission were: (1) the need to deter the particular type of offense charged and the capacity of a monetary penalty to achieve that result; (2) the extent of injury to innocent parties; (3) whether the allegedly unlawful conduct was widespread, or instead committed by a small group of corporate actors; (4) the level of intent on the part of the responsible individuals; and (5) the difficulty of detecting the unlawful behavior. *Id.*

40. Penalties Statement; *see also* Seaboard Report; Richard A. Spehr & Claudius O. Sokenu, *SEC Self-Policing Policy Presents Benefits and Pitfalls*, 7 ANDREWS SEC. LIT. & REG. REP. 17 (Feb. 27, 2002).

41. Penalties Statement, *supra* note 27, at 4.

42. *Id.*; *see, e.g., In re Rite Aid Corp.*, Exchange Act Rel. No. 46,099 (June 21, 2002). In *Rite Aid*, a financial 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 noted: “Rite-Aid cooperated in the Commission’s investigation of this matter, including declining to assert its attorney-client privilege with regard to various matters relevant to the

remedial steps is a factor supporting the imposition of a corporate penalty.”⁴³

Second, again drawing on the principles articulated in the Seaboard Report, the Commission stated 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.”⁴⁴ When considering whether to impose a monetary penalty, the Commission will consider the degree to which a corporation has self-reported an offense or otherwise cooperated with the investigation and remediation of the offense.⁴⁵

Much like the Seaboard Report before it, the Commission’s Penalties Statement should be commended for shedding light on a process that befuddles all but the most sophisticated of securities lawyers and for providing guidance that will help to focus settlement discussions between issuers and the Enforcement Division staff.⁴⁶ Rather disappointingly, however, the Penalties Statement did not address the one issue that generated the uproar in the first place: the ever-increasing size of monetary penalties that the Commission has been extracting from issuers settling allegations of securities law violations. In July 2003, for example, WorldCom Inc. agreed to pay \$2.25 billion in penalties to settle allegations of financial fraud.⁴⁷ In December 2003, Vivendi Universal, S.A. agreed to pay \$50 million in penalties to settle similar allegations.⁴⁸ And between March and December 2003, four financial services firms—Merrill Lynch, J.P. Morgan Chase, Citigroup, and CIBC World Markets—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

investigation 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.” *Id.*

43. Penalties Statement, *supra* note 27, at 4.

44. *Id.*

45. *Id.*

46. See Stephen M. Cutler, Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), available at www.sec.gov/news/speech/spch042904smc.htm; see also Sokenu, *supra* note 40.

47. SEC v. WorldCom, Inc., Litig. Rel. No. 18,219 (July 7, 2003) (indicating that the WorldCom settlement was to be satisfied, post-bankruptcy, by the company’s payment of \$500 million in cash and \$250 million worth of common stock in the reorganized company).

48. SEC v. Vivendi Universal, S.A., Litig. Rel. No. 18,523 (Dec. 24, 2003).

accounting fraud at Enron.⁴⁹ In the same period, the Commission settled charges relating to global research analyst conflict of interest matters with Citigroup for a staggering \$150 million and with Credit Suisse First Boston for \$75 million.⁵⁰ As then-SEC Enforcement Director Steven Cutler recognized in 2004, “[P]enalties 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.”⁵¹

Notwithstanding this failing, the Penalties Statement and the massive penalties that preceded its publication have helped to drive home the Commission’s now-consistent message: cooperation matters.

49. SEC v. Canadian Imperial Bank of Commerce, Litig. Rel. No. 18,517 (Dec. 22, 2003); SEC v. J.P. Morgan Chase & Co., Litig. Rel. No. 18,252 (July 28, 2003); *In re* Citigroup, Inc., Exchange Act Rel. No. 48,230 (July 28, 2003); SEC v. Merrill Lynch & Co., Litig. Rel. No. 18,038 (Mar. 17, 2003).

50. SEC v. Citigroup Global Mkts. Inc., Litig. Rel. No. 18,111 (Apr. 28, 2003); SEC v. Credit Suisse First Boston LLC, Litig. Rel. No. 18,110 (Apr. 28, 2003).

51. Cutler Remarks, *supra* note 1. In response to these astronomical settlements, Commissioner Atkins stated:

In the name of deterrence, we have seen heavier and heavier fines against corporations in the securities law context. Shareholders are harmed if prosecutors have one eye on the public relations effect of their actions. Shareholders are also harmed if management is all too willing to offer up the shareholders’ money—after all, it is other people’s money—in order to try to deflect personal responsibility of particular managers.

Commissioner Paul S. Atkins, Remarks before the Atlanta Chapter of the Nat’l Ass’n of Corp. Dirs. (Feb. 23, 2005), *available at* www.sec.gov/news/speech/spch022305psa.htm [hereinafter “Atkins Remarks”]. Commissioner Glassman echoed these sentiments when she stated that she disagrees with the appropriateness of imposing corporate penalties, “which, at the end of the day, are paid by the shareholders. If the shareholders have benefited from the fraud, then I would not normally oppose a penalty. But I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud.” *See* Commissioner Cynthia A. Glassman, SEC in Transition: What We’ve Done and What’s Ahead (June 15, 2005), *available at* www.sec.gov/news/speech/spch061505cag.htm. Commissioner Glassman was unconvinced by the “fair funds” argument because, as a vehicle to return monetary penalties to defrauded investors, they lead to the “anomalous result that we have shareholders paying corporate penalties that end up being returned to them through a Fair Fund—minus distribution expenses. This gets a headline, but it makes no sense to me—it is form over substance.” *Id.*

§ 2:2.3 NYSE Cooperation Memorandum

On September 14, 2005, the NYSE issued Information Memo 05-65 (the “Cooperation Memorandum”).⁵² The Cooperation Memorandum makes it clear that cooperation with the Exchange is an obligation of member firms. Specifically, the Cooperation Memorandum provides that disclosure to the Exchange of reportable matters “must be full, accurate, comprehensible, and timely.”⁵³ In addition, with respect to Exchange 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.”⁵⁴ Finally, the Cooperation Memorandum states that only a record of “proactive and exceptional” cooperation, such as, among other things, the waiver of attorney-client privilege, can serve to mitigate sanctions.⁵⁵

Approximately three weeks after issuing the Cooperation Memorandum, the Exchange issued a statement identifying a number of factors that it would consider in determining whether to impose sanctions.⁵⁶ Among other things, this statement clarified the role that a member firm’s perceived cooperation will play in that determination:

Members of the Exchange have a responsibility to cooperate with the Exchange’s regulatory program and are expected to comply with requests for documents, testimony and other information. No additional credit will be given for doing what is required by Exchange Rules. However, where a respondent can demonstrate a

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

53. *Id.* at 2.

54. *Id.*

55. *Id.* at 3. The implicit message that waiver is a necessary element of cooperation is modified somewhat, however, by the accompanying statement 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.” *Id.* at 4 (footnote omitted).

56. See Memorandum from Susan Merrill, Exec. V.P., NYSE Div. of Enforcement, to All Members, Member Orgs. and COOs, NYSE Info. Memo No. 05-77 (Oct. 7, 2005), available at [http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E8852570920068314A/\\$FILE/Microsoft%20Word%20-%20Document%20in%2005-77.pdf](http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E8852570920068314A/$FILE/Microsoft%20Word%20-%20Document%20in%2005-77.pdf).

record of disclosure and cooperation that is proactive and exceptional, the Enforcement Division will, in appropriate circumstances, give this factor weight in its consideration of a sanction. Conversely, a respondent's failure to cooperate fully and completely will support an increased sanction.⁵⁷

Like the SEC, the NYSE thus made it abundantly clear that it considers waiver to be the centerpiece of cooperation and that any corporation facing an investigation must be prepared to waive its privilege or find an alternative way to disclose all of the information that investigators might find relevant. Corporations that do not cooperate in these ways risk severe sanctions for their failure to comply.

§ 2:2.4 NASD Sanctions Guidelines

Not to be outdone, the NASD also announced in 2006 that it would place significant emphasis on a member firm's level of cooperation in determining whether and to what extent sanctions will be levied. Seven of the nineteen factors that the NASD stated it would consider in determining whether to impose sanctions relate to the respondent's level of cooperation, including whether the member firm:

- accepted responsibility for and acknowledged the misconduct to a regulator prior to detection and intervention by a regulator;
- voluntarily employed subsequent corrective measures, prior to detection or intervention by a regulator, to revise general and/or specific procedures to avoid recurrence of misconduct;
- voluntarily and reasonably attempted, prior to detection and intervention, to pay restitution or otherwise remedy the misconduct;
- at the time of the violation had developed reasonable supervisory, operational, and/or technical procedures or controls that were properly implemented;
- attempted to conceal its misconduct or to lull into inactivity, mislead, deceive, or intimidate a customer, or regulatory authorities;
- provided substantial assistance to NASD Regulation in its examination and/or investigation of the underlying misconduct, or whether the respondent attempted to delay NASD Regulation's investigation, to conceal information from NASD Regulation, or to provide inaccurate or misleading testimony or documentary information to NASD Regulation;

57. *Id.* at 4.

- disciplined respondent for the misconduct at issue prior to regulatory detection.⁵⁸

This regime of cooperation mirrored that of the NYSE and the SEC. Since both the NYSE and the NASD were regulated by the SEC, it is no surprise that both thought it reasonable and appropriate to follow in the footsteps of the SEC.

§ 2:2.5 Federal Sentencing Guidelines

The Federal Sentencing Guidelines—like the Seaboard Report, the Thompson Memorandum, and the NYSE and NASD guidelines—place significant emphasis on corporate cooperation and compliance programs in determining the penalties that corporations will face for violations of federal criminal laws.⁶⁰ The section of the Guidelines devoted to the sentencing of organizations is intended to “offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program.”⁶¹ Section 8B2.1, entitled “Effective Compliance and Ethics Program,” provides that, to have a compliance and ethics program that will factor favorably into a sentencing decision, an organization shall “[e]xercise due diligence to prevent and detect criminal conduct” and promote a culture that encourages ethical conduct and compliance with the law.⁶² Section 8B2.1(b) identifies in detail the minimum requirements for an effective compliance program.⁶³

Section 8C2.5, entitled “Culpability Score,” provides a methodology that district court judges must consider in deciding whether to impose a fine on a corporation.⁶⁴ The section provides still another strong incentive for companies to develop effective compliance programs and self-report wrongdoing. For example, section 8C2.5(f) reduces the fine faced by a company that is found to have had an effective compliance and ethics program.⁶⁵ Similarly, section 8C2.5(g) reduces the fine to be imposed upon a company that self-reports wrongdoing, cooperates fully in the investigation, and accepts responsibility for its

58. See NASD, *Principle Considerations in Determining Sanctions* (2006), available at www.nasd.com/RegulatoryEnforcement/NASDEnforcementMarketRegulation/NASDSanctionGuidelines/PrincipalConsiderationsinDeterminingSanctions/index.htm.

59. [Reserved.]

60. See U.S. SENTENCING GUIDELINES MANUAL § 8B2.1 (2004).

61. *Id.* ch. 8, intro. cmt.

62. *Id.* § 8C2.1.

63. See *id.* § 8C2.1(b).

64. See *id.* § 8C2.5.

65. See *id.* § 8C2.5(f).

actions.⁶⁶ The application notes clarify that, to qualify for a reduction under section 8C2.5(g)(1) or (g)(2), cooperation must be timely and thorough.⁶⁷ Just as the Sentencing Guidelines reward effective compliance programs, self-reporting, and cooperation, they also punish a corporation that is found to have obstructed justice and impeded a government investigation.⁶⁸

Effective November 1, 2006, the Sentencing Commission deleted from the application notes to section 8C2.5 the requirement that a company waive its attorney-client and work product privileges in order to achieve a culpability reduction under section 8C2.5(g) whenever waiver is deemed “necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.”⁶⁹ This requirement was deleted in response to testimony at public hearings before the Sentencing Commission in March 2006 urging its repeal.⁷⁰

Although this amendment was certainly a welcome development to any organization facing indictment, the relief it provided is minor: in practice, corporations still face tremendous pressure to waive privilege in connection with federal criminal investigations because of the aggressive pro-waiver stance adopted by the Department of Justice in the Thompson and McNulty Memoranda, as the following sections describe.

§ 2:2.6 The Thompson Memorandum

[A] History and Overview

On January 20, 2003, the Justice Department released a memorandum by then-Deputy Attorney General Larry D. Thompson entitled “Principles of Federal Prosecution of Business Organizations” (the “Thompson Memorandum”).⁷¹ The Thompson Memorandum provided

66. See *id.* § 8C2.5(g).

67. See *id.* § 8C2.5 cmt. n.12.

68. See *id.* § 8C2.5(e).

69. *Id.* § 8C2.5(g) cmt. n.12 (Nov. 2004). The waiver requirement had appeared for the first time just two years earlier on the tails of the Seaboard Report and the Thompson Memorandum. See *infra* section 2:2.6 (discussing the Thompson Memorandum).

70. See, e.g., The Decline of the Attorney-Client Privilege in the Corporate Context: Survey Results Presentation/Testimony before the United States Sentencing Commission (Mar. 15, 2006), available at www.ussc.gov/hearings/03_15_06/AGD03_15.HTM (testimony of Susan Hackett).

71. See Larry D. Thompson, Deputy Attorney General, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), available at www.usdoj.gov/dag/cftf/corporate_guidelines.htm [hereinafter “Thompson Memorandum”].

a set of principles designed to guide federal prosecutors in deciding whether to prosecute a business organization. In force from January 2003 until it was superseded by the McNulty Memorandum on December 12, 2006, the Thompson Memorandum revised an earlier Justice Department memorandum known as the Holder Memorandum.⁷² The essential purpose underlining the revisions was “increased emphasis on and scrutiny of the authenticity of a corporation’s cooperation.”⁷³ To further this purpose, the Thompson Memorandum outlined nine factors that federal prosecutors must consider in deciding whether to bring charges against a corporation.⁷⁴ All but one of these factors—the adequacy of the prosecution of individuals responsible for the corporation’s malfeasance—appeared in the Holder Memorandum. Unlike the Holder Memorandum, however, the Thompson Memorandum was binding on federal prosecutors.⁷⁵

In addition to factors such as the nature and seriousness of the offense, the pervasiveness of wrongdoing within the corporation, and the corporation’s prior history, three of the factors highlighted by the Thompson Memorandum dealt squarely with the corporation’s cooperative efforts:

4. the corporation’s timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection . . .
5. the existence and adequacy of the corporation’s compliance program . . . [and]

72. Compare Thompson Memorandum, with Eric E. Holder, Jr., Deputy Attorney General, Federal Prosecution of Corporations (June 16, 1999), available at www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html.

73. Thompson Memorandum, at Introduction.

74. The nine factors are: (i) the nature and seriousness of the offense; (ii) the pervasiveness of the wrongdoing within the corporation; (iii) the corporation’s history of similar conduct; (iv) the corporation’s timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents; (v) the existence and adequacy of the corporation’s compliance program; (vi) the corporation’s remedial actions; (vii) collateral consequences of prosecution; (viii) the adequacy of the prosecution of individuals responsible for the corporation’s malfeasance; and (ix) the adequacy of remedies such as civil or regulatory enforcement actions. *Id.* § II.A.

75. See DOJ, Criminal Resource Manual § 163 (Oct. 21, 2005) (“The Thompson Memorandum sets forth nine factors that federal prosecutors *must consider* in determining whether to charge a corporation or other business organization.”) (emphasis added); see also *United States v. Stein*, 435 F. Supp. 2d 330, 338 & n.12 (S.D.N.Y. 2006).

6. the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies. . . .⁷⁶

In discussing the fourth factor, the Thompson Memorandum encouraged prosecutors to consider what it viewed as the “completeness” of a corporation's disclosure, including, among other things, the willingness of a corporation to

- waive attorney-client and work product protections, particularly with respect to an internal investigation and communications between specific officers, directors and employees, and counsel;
- refuse to advance attorneys' fees to alleged wrongdoers;
- sanction culpable employees; and
- refuse to enter into joint defense agreements with those employees.⁷⁷

[B] Response and Criticism

The release of the Thompson Memorandum produced a well-documented outcry within the business and legal communities.⁷⁸ Among the outspoken critics of the Thompson Memorandum were the American Bar Association (ABA), the U.S. Chamber of Commerce, three former U.S. Attorneys General, three former U.S. Deputy Attorneys General, four former Solicitors General, and other former prosecutors, some of whom testified at hearings before the House and Senate judiciary committees.⁷⁹

Although criticisms of the Thompson Memorandum are manifold, two are of particular note. First is the view that the Thompson Memorandum contributed to a coercive “culture of waiver,” in which

76. See Thompson Memorandum, § II.A.

77. *Id.* § VI.B.

78. 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”]; Editorial, *Memo to Gonzales*, WALL ST. J., Sept. 8, 2006, at A14; John Hasnas, Op-Ed, *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”].

79. See *Memo to Gonzales*, *supra* note 78, at A14 (reporting on a memorandum critical of the Thompson Memorandum sent by former top Justice Department officials from five different administrations); see also Senate Hearings, *supra* note 78; House Hearings, *supra* note 78.

“governmental agencies believe it is reasonable and appropriate to expect a corporation under investigation to broadly waive [its] attorney client privilege.”⁸⁰ Regardless of whether consideration of a corporation’s willingness to waive privilege and withhold payment of attorneys’ fees was mandatory under the Thompson Memorandum,⁸¹ in the view of former U.S. Attorney General Edwin Meese, the lack of specific and concrete language in the Thompson Memorandum explaining how prosecutors will decide whether to indict, or what weight they will assign to various factors, creates an environment in which corporations effectively must view the factors as mandatory.⁸² The fear of indictment has doubtless exacerbated corporations’ concern of being labeled uncooperative. As one observer noted, “[i]n the current climate few, if any, public companies can afford the risk of possible indictment and the myriad of collateral consequences, not the least of which is the diminution of shareholder value.”⁸³

A second and related criticism is that the emphasis placed on waiver of the attorney-client privilege and work product protections threatens to create a counterproductive climate of distrust between corporations and their employees and could undermine companies’ internal compliance programs and procedures. As noted by the ABA,

[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.⁸⁴

Such an outcome could potentially undermine the very enforcement objectives that prompted the Thompson Memorandum in the first place.

The problems created by the “culture of waiver” reflected in the Thompson Memorandum have been compounded by the broad hostility of the courts to 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

80. Senate Hearings, *supra* note 78 (testimony of Edwin Meese III).

81. The DOJ has denied that consideration of these factors was mandatory under the Thompson Memorandum, notwithstanding its description as such in the Criminal Resource Manual. *Compare* Senate Hearings, *supra* note 78 (testimony of Paul J. McNulty, Deputy Attorney General), with DOJ, Criminal Resource Manual § 163 (Oct. 21, 2005).

82. Senate Hearings, *supra* note 78 (testimony of Edwin Meese III).

83. *Id.* (testimony of Mark B. Sheppard).

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

argued that such productions should be viewed as “selective” or “limited” waivers that do not affect the corporation’s right to withhold the documents as privileged in suits brought by private civil litigants. With the exception of the Eighth Circuit in *Diversified Industries, Inc. v. Meredith*,⁸⁵ every federal court of appeals that has been asked to adopt that rule has declined.⁸⁶ Corporations have fared no better in advocating the adoption of the selective or limited waiver with respect to the work product privilege: only the Fourth Circuit has accepted the concept of selective or limited waiver in this context,⁸⁷ while the First, Third, Sixth, Eighth, and Tenth Circuits have rejected it, hewing instead to the traditional view that the intentional disclosure of a privileged document to any outside entity destroys the protections of the privilege against all others.⁸⁸ Some circuits have left open the possibility that a selective or limited waiver rule for work product-protected information might be recognized in limited circumstances, such as where disclosure takes place subject to a confidentiality agreement.⁸⁹ While in some jurisdictions a confidentiality agreement might go some way toward protecting privileged information, at least

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85. *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1977) (en banc).
86. *In re Qwest Commc’ns Int’l, Inc.*, 450 F.3d 1179, 1200 (10th Cir.), *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. Mass. Inst. of Tech.*, 129 F.3d 681, 686 (1st Cir. 1997); *Westinghouse Elec. Corp. v. Republic of Philippines*, 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).
87. *See Martin Marietta*, 856 F.2d at 623, 626 (adopting selective waiver for opinion work product but declining to apply selective waiver to protect non-opinion work product).
88. *See Qwest*, 450 F.3d at 1192 (concluding that selective waiver did not apply to work product disclosed to government under the circumstances); *Columbia/HCA Healthcare*, 293 F.3d at 306–07 (concluding that many of the reasons for disallowing selective waiver of attorney-client privilege also applied to the work product doctrine); *Mass. Inst.*, 129 F.3d at 687 (rejecting selective waiver for non-opinion work product); *Westinghouse*, 951 F.2d at 1429 (rejecting selective waiver of work product where disclosures were inconsistent with the objectives of the work product doctrine); *In re Chrysler Motors Corp. Overnight Evaluation Program Litig.*, 860 F.2d 844, 846–47 (8th Cir. 1988) (rejecting selective waiver for non-opinion work product).
89. *See, e.g., In re Steinhardt Partners*, 9 F.3d 230, 236 (2d Cir. 1993) (declining to adopt a per se rule that all voluntary disclosures to the government waive work product protection on the grounds that such a rigid rule “would fail to anticipate situations in which the disclosing party and the government may share a common interest in developing legal theories and analyzing information, or situations in which the SEC and the disclosing party have entered into an explicit agreement that the SEC

three circuits have held that the disclosure of privileged information pursuant to a confidentiality agreement still destroys privilege.⁹⁰

§ 2:2.7 The McNulty Memorandum

On December 12, 2006, in response to the growing criticism of policies outlined in the Thompson Memorandum and a supplemental memorandum by Acting Deputy Attorney General Robert McCallum,⁹¹ Deputy Attorney General Paul J. McNulty released what is now known as the McNulty Memorandum.⁹² The McNulty Memorandum

will maintain the confidentiality of the disclosed materials”); *In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1372–75 (D.C. Cir. 1984) (holding that whether disclosure of work product to the SEC constituted a waiver rested on three factors: (1) the party claiming privilege sought to use it in a way inconsistent with the purpose of the privilege; (2) “appellants had no reasonable basis for believing that the disclosed materials would be kept confidential by the SEC”; and (3) no public policy behind the work product privilege demanded an exception to the waiver rule under the circumstances); *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) (noting that the Seventh Circuit has not yet decided its position on selective waiver and that selective waiver has been disfavored by district courts therein, but holding that, under the circumstances, the defendant had not waived its privilege with respect to documents produced to the SEC because it had entered into a confidentiality agreement with SEC); *In re Natural Gas Commodity Litig.*, No. 03 Civ. 6186VMAJP, 2005 WL 1457666, at *9 (S.D.N.Y. June 21, 2005) (holding that, under *Steinhardt*, the defendants had not waived work product protection because they had explicit confidentiality agreements with the government agencies who had received the protected materials, and because the plaintiffs had not shown a substantial need for the work product since they had received the underlying documents on which the analyses were based).

90. See *Qwest*, 450 F.3d at 1194 (dismissing the notion that confidentiality agreements with enforcement agencies warrant the selective waiver rule under the circumstances presented); *Columbia/HCA Healthcare*, 293 F.3d at 307 (rejecting the notion of selective waiver under the circumstances, notwithstanding the existence of a confidentiality agreement); *Chrysler Motors*, 860 F.2d at 847 (holding that an agreement with one’s adversary not to disclose work product materials to a third party could not protect the materials from waiver).
91. See Memo from Acting Dep. Att’y Gen. Robert McCallum to Heads of Dep’t Components and U.S. Att’ys, *Waiver of Corporate Attorney-Client and Work Product Protection* (Oct. 21, 2005), available at www.corporatecrimereporter.com/documents/AttorneyClientWaiverMemo.pdf.
92. See Memo from Dep. Att’y Gen. Paul J. McNulty to Heads of Dep’t Components and U.S. Att’ys, *Principles of Federal Prosecution of Business Organizations* 1–2 (Dec. 12, 2006), available at www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf (discussing the role of public criticism of the Thompson Memorandum in issuing new guidance) [hereinafter “McNulty Memorandum”]; Carrie Johnson, *Shift in Corporate Prosecution Ahead: Government to Stiffen Rules on Indicting Companies*, WASH. POST, Nov. 30, 2006, at D1.

did not retreat from the Thompson Memorandum's view that the use of a joint defense agreement and the failure to sanction employees engaged in wrongful conduct is probative of whether a corporation is shielding its culpable employees and agents from a government investigation.⁹³ However, the McNulty Memorandum diverges from its predecessor in two key respects: First, it limits—but does not eliminate—the circumstances under which prosecutors may seek waivers of privilege and provides a procedure for seeking such waivers,⁹⁴ and, second, it takes the position that prosecutors generally should not view a corporation's decision to advance attorneys' fees to its employees or agents under investigation and indictment as a sign that the corporation is not cooperating fully with the government.⁹⁵

[A] Privilege Waivers

With respect to the first of these policies, the McNulty Memorandum dictates that prosecutors may only request waivers if there exists a "legitimate need" for the waiver and sets forth a balancing test for determining whether such a need exists.⁹⁶ If a prosecutor determines that there exists a "legitimate need," the McNulty Memorandum

93. McNulty Memorandum, *supra* note 92, at 11. The American Bar Association 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 actions against their employees in some cases in return for cooperation credit, long before any guilt is established." Press Release, Statement by ABA President Karen J. Mathis Regarding Revisions to the Justice Department's Thompson Memorandum (Dec. 12, 2006), available at www.abanet.org/abanet/media/statement/statement.cfm?releaseid=59 [hereinafter "ABA Press Release"]. 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*, 22 LEGAL BACKGROUNDER (Wash. Legal Found.) No. 3 (Jan. 19, 2007).

94. McNulty Memorandum, at 8–11.

95. *Id.* at 11–12.

96. *Id.* at 8–9. In determining whether there is a "legitimate need" for privileged information, a prosecutor is to consider: "1. the likelihood and degree to which the privileged information will benefit the government's investigation; 2. whether the information sought can be obtained in a timely and complete fashion by using alternative means that do not require waiver; 3. the completeness of the voluntary disclosure already provided; and 4. the collateral consequences to a corporation of a waiver." *Id.* at 9. Apart from noting that a "legitimate need for the information is not established by concluding it is merely desirable or convenient to obtain privileged information," *id.* at 8–9, the McNulty Memorandum fails to explain how a prosecutor is to balance these factors. In practice, therefore, it is the rare accounting fraud or other complex securities law investigation that will fail the test.

counsels prosecutors to “seek the least intrusive waiver necessary to conduct a complete and thorough investigation” and sets forth a tiered approach to seeking waivers.⁹⁷ With respect to “purely factual information . . . relating to the underlying misconduct,” however, the McNulty Memorandum continues to permit prosecutors to consider a corporation’s response to a waiver request in determining whether the corporation cooperated in the government’s investigation.⁹⁸

It is difficult to see how this new waiver framework, which seemingly favors form over substance, addresses the fundamental concerns that prompted calls for revisions to the Thompson Memorandum in the first place. Moreover, the McNulty Memorandum does nothing to address the issue of selective or limited waiver and 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 the way in which

97. *Id.* at 9–11. Category I information is information that is “purely factual information, which may or may not be privileged, relating to the underlying misconduct,” and 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.” *Id.* at 9. The McNulty Memorandum instructs that prosecutors *should* request Category I information. Before doing so, however, a prosecutor must obtain written authorization from the U.S. 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.” *Id.*

Category II information is 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. *Id.* at 10. The McNulty Memorandum provides that prosecutors *may* request Category II information only in “rare circumstances,” and only if Category I information provides “an incomplete basis to conduct a thorough investigation.” Before requesting all but two types of Category II information, the prosecutor must obtain advance written authorization from the Deputy Attorney General (carving out exceptions to the authorization requirement for requests for privileged communications relevant to the advice-of-counsel defense or falling within the crime-fraud exception). Unlike with Category I information, moreover, a prosecutor may 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.” *Id.* Furthermore, federal prosecutors are not required to obtain any authorization to receive information in either category “if the corporation voluntarily offers privileged documents without a request by the government.” *Id.* at 11.

98. *Id.* at 9.

prosecutors use prior-settled cases when negotiating 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 cooperating with the government on the table under the assumption that prosecutors will not hold that against it when the time comes to make charging decisions. Even if it took that risk, the corporation would likely find it difficult to justify its decision to its shareholders if it declines to waive privilege and is subsequently indicted, given the daunting collateral consequences that often follow. From a corporate perspective, the reality is that the distinction between “favorable” and “not unfavorable” treatment drawn by the McNulty Memorandum carries no practical import: corporations still face tremendous pressure to waive privilege to avoid prosecution.

Early reaction to the McNulty Memorandum questions whether these new procedures meaningfully address the criticisms levied at the Thompson Memorandum. In the view of the ABA, 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.”⁹⁹ The bottom line is that prosecutors can still lean on corporations to produce privileged information, while dangling cooperation credit as an incentive. It also remains to be seen how stringently U.S. Attorneys will apply the “legitimate need” and other tests enunciated by the McNulty Memorandum.

[B] Advancing Attorneys’ Fees

As noted above, the McNulty Memorandum also diverges from the Thompson Memorandum by taking the position that a corporation’s advancement of attorneys’ fees to allegedly culpable employees or agents should not factor into any charging decision.¹⁰⁰ This reversal suggests tacit acceptance by the Justice Department of a pair of 2006

99. ABA Press Release, *supra* note 93.

100. McNulty Memorandum, at 11–12. Corporations should, however, be mindful 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.” *Id.* at 11 n.3. 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.” *Id.* As with Category II information, however, a prosecutor must obtain approval from the Deputy Attorney General before considering this factor in the charging decision. *Id.*

decisions handed down by Judge Lewis Kaplan of the Southern District of New York.¹⁰¹

First, in *United States v. Stein (Stein I)*, Judge Kaplan ruled that the Thompson Memorandum's guidelines on the advancement of legal fees by corporate employers, both alone and coupled with the action of the U.S. Attorney's Office, violated the Fifth and Sixth Amendment rights of the employee-defendants.¹⁰² Then, in *United States v. Stein (Stein II)*, Judge Kaplan suppressed statements by two of the employee-defendants on the grounds that they had been "deliberately" coerced by the government.¹⁰³ Specifically, Judge Kaplan found that, under pressure from the government to cooperate, the employer had pressured its employees to grant government requests for pre-indictment interviews and threatened to stop payment of legal fees should the employees refuse to cooperate.¹⁰⁴

The McNulty Memorandum's revision to the Thompson Memorandum in this regard should give corporations greater comfort to advance legal fees to current and former employees without wondering whether the government will view its actions as a failure to cooperate.¹⁰⁵

101. The Second Circuit recently held that Judge Kaplan had improperly exercised ancillary jurisdiction over the employee-defendants' civil actions against their employer to compel the advancement of legal fees. *Stein v. KPMG LLP*, 486 F.3d 753 (2d Cir. 2007). However, the court took pains to note that its decision did not address the merits of Judge Kaplan's holding that the constitutional rights of the employee-defendants' had been violated, emphasizing that if Judge Kaplan was correct about the constitutional implications of the government's actions in reliance on the Thompson Memorandum, the proper remedy was to dismiss the criminal indictment. *Id.* at 762–63. Judge Kaplan has now taken the Second Circuit up on its invitation, dismissing the government's indictment against most of the defendants. *See United States v. Stein*, 495 F. Supp. 2d 390 (S.D.N.Y. 2007) (*Stein III*).

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

103. *United States v. Stein*, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) (*Stein II*).

104. *Id.* at 338.

105. In fact, in a dramatic departure from its former position, the Justice Department took the position in a recent Southern District of Texas filing that a company's willingness to advance attorneys' fees to employees under investigation helped to demonstrate the completeness of its cooperation with the government. *See United States v. Baker Hughes Servs. Int'l, Inc.*, No. H-07-129, Dkt. Entry #9, at 4 (S.D. Tex. Apr. 24, 2007). It remains to be seen whether the government will continue to take this position in future cases. For a detailed discussion of the *Stein* decisions' influence on SEC and DOJ policies with respect to compelled waiver, see David Z. Seide, *Compelled Waivers of the Attorney-Client Privilege*, 39-21 REV. SEC. & COMMODITIES REG. 235 (2006).

§ 2:3 The Benefits of Conducting Internal Investigations

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 to minimize civil penalties. Among other things, corporations have waived privileges, required employees to make themselves accessible to enforcement agencies, provided the results of internal investigations and interviews, declined to pay attorneys' fees, and revamped their internal compliance programs.¹⁰⁶

§ 2:3.1 Rewards for Cooperation

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 ("Statoil"), a Norwegian corporation that issues American Depositary Shares registered pursuant to section 12(b) of the Exchange Act.¹⁰⁷ In doing so, the Commission considered Statoil's remedial actions and cooperation with the Commission in its investigation of alleged violations of the Foreign Corrupt Practices Act (FCPA). Specifically, Statoil was alleged to have bribed an Iranian government official in order to assist it in obtaining a contract to develop an oil and gas field in Iran and of failing to properly account for the illegal payments or to accurately describe the contract in its books and records. In its Release,

106. See, e.g., *Stein I*, 435 F. Supp. 2d 330 (chronicling the numerous actions taken by KPMG in its efforts to avoid indictment); Deferred Prosecution Agreement, *United States v. AIG-FP Pagic Equity Holding Corp.* (W.D. Pa. filed Nov. 30, 2004) [hereinafter "AIG Agreement"]; Deferred Prosecution Agreement, *United States v. Computer Assocs. Int'l*, Crim. No. 04-837 (ILG) (E.D.N.Y. filed Sept. 24, 2004) [hereinafter "CA Agreement"]; Deferred Prosecution Agreement, *United States v. Am. Online, Inc.*, Crim. No. 1:04 M 1133 (E.D. Va. 2005) [hereinafter "AOL Agreement"]; Siobhan Hughes, *Prudential Will Pay \$600 Million*, WALL ST. J., Aug. 29, 2006, at C11; DOJ Press Release, DOJ, *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 www.usdoj.gov/criminal/press_room/press_releases/2006_4809_10-16-06schnitzerfraud.pdf [hereinafter "Schnitzer Press Release"]; DOJ Press Release, *Bristol-Myers Squibb Charged with Conspiring to Commit Securities Fraud; Prosecution Deferred for Two Years* (June 15, 2005), available at www.usdoj.gov/usao/nj/press/files/bms0615_r.htm; Press Release, DOJ, *PNC ICLC Corp. Enters into Deferred Prosecution Agreement with the United States* (June 2, 2003), available at www.usdoj.gov/opa/pr/2003/June/03_crm_329.htm [hereinafter "PNC Press Release"].

107. *In re Statoil, ASA*, Exchange Act Rel. No. 54,599, 2006 WL 2933839, at *1-2 (Oct. 13, 2006).

the Commission extensively described Statoil's cooperation.¹⁰⁸ Although the Commission ordered 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.¹⁰⁹

Similarly, in April 2006, the Commission ordered Oil States International, Inc. to cease and desist from future violations of the federal securities laws without seeking monetary penalties because it was proactive in discovering the securities laws violations and conducting an internal investigation, voluntarily reported the investigation's findings to the Commission and the Justice Department, and cooperated fully with the SEC's investigation.¹¹⁰

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 NEF officers engaged in a fraudulent and improper reclassification of over \$100 million in NEF expenses, directly resulting in the disclosure of

108. 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 attorneys' fees. Statoil's Board of Directors has 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.

109. *Id.* at *10. The Justice Department also required Statoil to enter into a three-year deferred prosecution agreement, in a parallel criminal investigation. *See* DOJ Press Release, U.S. Resolves Probe Against Oil Company that Bribed Iranian Official (Oct. 13, 2006), *available at* www.usdoj.gov/usao/nys/pressreleases/October06/statoildeferredprosecutionagreementpr.pdf.

110. *In re* Oil States Int'l, Inc., Exchange Act Rel. No. 53,732, 2006 WL 1113519, at *1-4 (Apr. 27, 2006).

materially false overstatements of net income in financial statements filed with the Commission.¹¹¹ 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.”¹¹²

§ 2:3.2 Punishment for Inadequate Cooperation

Since the Seaboard Report, the SEC has not only rewarded cooperation; it has also, in certain notable cases, punished companies for inadequate cooperation. For example, in May 2004, in a statement that explicitly emphasized the respondent’s failure to cooperate in SEC investigations, the Commission announced that it had reached a settlement agreement with Lucent Technologies Inc. over charges that Lucent had engaged in accounting fraud.¹¹³ In relevant part, 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:

- incomplete and untimely document production, including Lucent’s failure to disclose where a relevant document was preserved, which impeded the SEC’s ability to conduct its investigation;
- that, 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, thereby “undermin[ing] both the spirit and letter of its agreement in principle with the staff”;
- that, 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

111. SEC v. Faria, Litig. Rel. No. 19,656, 2006 WL 985304, at *1–*2 (Apr. 13, 2006).

112. *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.” *Id.*

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

action,” an action that the SEC viewed as contrary to public interest; and

- that Lucent failed to provide timely and full disclosure to the SEC staff on “a key issue concerning indemnification of employees.”¹¹⁴

Since the Lucent settlement, the Commission has cited lack of cooperation as the basis for imposing relatively large civil penalties in other recent enforcement actions as well.¹¹⁵

§ 2:3.3 **Deferred and Non-Prosecution Agreements in Criminal Actions**

With respect to criminal investigations, cooperation has helped many corporations avoid indictment. Correspondingly, there has been an increased use of deferred prosecution agreements and non-prosecution agreements.¹¹⁶ In a typical deferred prosecution agreement, the government files a criminal complaint against the corporation, and the corporation accepts and acknowledges responsibility for the allegedly unlawful conduct. Based on the corporation’s acceptance of

114. *See id.*

115. *See, e.g.*, SEC Press Release, SEC Settles with Raytheon Company, Former CEO, and Subsidiary Controller for Improper Disclosure and Accounting Practices (June 28, 2006) (announcing that Raytheon agreed to a \$12 million civil penalty); SEC v. CIBC Mellon Trust Co., Litig. Rel. No. 19,081, 2005 WL 372505, at *1 (Feb. 16, 2005) (\$5 million); SEC Press Release, SEC Charges Wachovia Corp. with Proxy Disclosure and Other Reporting Violations Involving the 2001 Merger Between First Union Corp. and Old Wachovia Corp. (Nov. 4, 2004) (\$37 million); SEC v. Gemstar-TV Guide Int’l, Inc., Litig. Rel. No. 18,760, 2004 WL 1404277, at *1–*2 (June 23, 2004) (\$10 million); SEC v. Symbol Tech., Inc., Litig. Rel. No. 18,734, 2004 WL 1217620, at *2–*3 (June 3, 2004) (\$37 million).

116. *See* sources cited *supra* note 106; *see also* U.S. Attorney S.D.N.Y. Press Release, U.S. Reaches Non-Prosecution Agreement With Royal Ahold, N.V. (Sept. 28, 2006) [hereinafter “Royal Ahold Press Release”]; U.S. Attorney N.D. Ala. Press Release, Statement of U.S. Attorney Alice H. Martin Regarding Non-Prosecution Agreement Reached with HealthSouth Corporation (May 18, 2006) [hereinafter “HealthSouth Press Release”]; U.S. Attorney, E.D.N.Y. Press Release, 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) [hereinafter “BNY Press Release”]; U.S. Attorney S.D.N.Y. Press Release, 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 twenty-three deferred and non-prosecution agreements with major U.S. companies between 2002 and 2005, compared with eleven such agreements between 1992 and 2001).

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 will defer prosecution for a period of time (often between twelve and twenty-four months). If the corporation complies with its obligation under the deferred prosecution agreement, the complaint is dismissed with prejudice at the end of the deferral period.¹¹⁷ A typical non-prosecution agreement imposes similar obligations on the corporation and places the corporation in a probationary period; if the corporation fails to comply with the obligations of the non-prosecution agreement, it can be prosecuted.¹¹⁸

The Justice Department’s increased use of these agreements also follows the very public June 2002 demise of Arthur Andersen LLP, which was convicted of obstruction of justice for its destruction of documents relating to its audit of Enron.¹¹⁹ Among the many notable aspects of the Andersen investigation, indictment, and subsequent trial was Andersen’s failure to reach agreement with the Justice Department on the terms of a deferred prosecution agreement that could have averted the trial.¹²⁰

Since the *Andersen* case, numerous other companies have entered into deferred prosecution agreements. These include Bristol-Myers Squibb Company; PNC ICLC Corp., a subsidiary of PNC Financial Services Group, Inc.; AIG-FP PAGIC Equity Holding Corp., a

117. See, e.g., AOL Agreement, *supra* note 106; CA Agreement, *supra* note 106; AIG Agreement, *supra* note 106.

118. See, e.g., HealthSouth Corporation Non-Prosecution Agreement (N.D. Ala. filed May 17, 2006), available at www.usdoj.gov/usao/aln/Docs/May%202006/healthsouthnonpros2.pdf.

119. See Press Release, SEC Statement Regarding Andersen Case Conviction (June 15, 2002), available at 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”).

120. See Jonathan D. Glater, *Government Rejects Andersen Proposal*, N.Y. TIMES, Apr. 26, 2002, at C6; see also Kurt Eichenwald & Jonathan D. Glater, *Andersen Sends New Proposal for Settlement to Government*, N.Y. TIMES, Apr. 25, 2002, at C1. According to the N.Y. 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. *Id.* at C1. After prosecutors ended negotiations, 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.

subsidiary of AIG; SSI International Far East Ltd. (“SSI Korea”), a subsidiary of Schnitzer Steel Industries Inc.; and Prudential Equity Group LLC, a subsidiary of Prudential.¹²¹ Royal Ahold, N.V., HealthSouth Corporation, Adelphia Communications, and the Bank of New York, among others, have also recently entered into non-prosecution agreements.¹²² In press releases and news reports, the Justice Department often points to the corporation’s level of cooperation as a basis for concluding deferred or non-prosecution agreements.¹²³

§ 2:4 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. This enforcement regime creates inexorable and often irresistible pressure on corporate counsel, who have little choice but to conduct internal investigations and to share the results of those investigations with potentially interested government investigators. This conclusion marks only the beginning of the story, however. This pressure to cooperate early and fully—in short, to demonstrate “extraordinary cooperation”—raises numerous difficult questions for corporations and their in-house and outside lawyers, including:

- How broad must the investigation be?
- Will the government accept its results?¹²⁴
- Is it wise to enter into a joint defense agreement with potentially culpable employees?¹²⁵

121. See authorities cited *supra* note 106; Cohen, *supra* note 116.

122. See authorities cited *supra* note 116.

123. See, e.g., Schnitzer Press Release, *supra* note 106; PNC Press Release, *supra* note 106; Royal Ahold Press Release, *supra* note 116; HealthSouth Press Release, *supra* note 116; BNY Press Release, *supra* note 116.

124. See Andrew Longstreth, *In the New Era of Internal Investigations, Defense Lawyers Have Become Deputy Prosecutors*, 27 AM. LAW. 68 (Feb. 2005) (discussing the SEC proceeding against Symbol Tech, Inc., in which the SEC rejected as untrustworthy the internal investigation performed by one of the company’s regular outside law firms, and effectively required Symbol Tech to hire a second outside firm to conduct a new and more vigorous investigation). See also SEC v. Symbol Tech., Litig. Rel. 18,734 (June 30, 2004).

125. The McNulty Memorandum teaches prosecutors that “a corporation’s promise of support to culpable employees . . . through providing information to the employees about the government’s investigation pursuant to a joint defense agreement, may be considered by the prosecutor in weighing the extent and value of a corporation’s cooperation.”

- When may privilege be preserved?
- What liability exposure might the investigation create for individual employees, officers, and directors?¹²⁶
- When must internal sanctions be meted out?
- What are the implications of cooperation for current or future private civil litigation?¹²⁷
- Can the corporation continue to carry out its contractual obligations to employees implicated in the investigation?
- With respect to such persons, must it refrain from extending any benefit not required by contract?
- And—particularly where these obligations bear on employees' ability to obtain representation—what litigation costs and liability exposure might a corporation incur in yielding to government pressure to withhold funds?¹²⁸

In short, in this environment, counsel must carefully navigate the treacherous course between the collateral risks posed by the government's demands for concessions in parallel or future proceedings and the danger that the government will view even well-meaning resistance to its demands as a sign that the client is not sufficiently

126. Consider, for example, the DOJ's investigation of former Computer Associates International, Inc. Chief Financial Officer, Ira Zar. Zar pleaded guilty to federal charges of securities fraud, conspiracy to commit securities fraud, and conspiracy to obstruct justice, based on allegations that he and other officers and executives engaged in a scheme to fraudulently report revenues by artificially extending months for accounting purposes, and to conceal this practice from outside auditors. Of particular note is the fact that the government's obstruction of justice charge was rooted in the allegation that Zar made false statements to the company's lawyers and audit committee—not to government officials. In essence, in the government's view, Computer Associates' decision to conduct an internal investigation and to interview Zar in the course of that investigation exposed Zar to additional criminal liability. See Kenneth N. Gilpin, *Guilty Pleas in Computer Associates Case*, INT'L HERALD TRIB., Apr. 9, 2004, at 11; see also Information ¶¶ 10-17, at 5-9, *United States v. Zar*, Crim. No. 04-331 (ILG) (E.D.N.Y. filed Apr. 8, 2004), available at www.usdoj.gov/dag/cftf/chargingdocs/zarinfo.pdf.

127. For example, entry into a deferred prosecution or non-prosecution agreement can have significant implications in the event of parallel investigations and subsequent litigation. Such agreements almost always contain a stipulation of facts that the target of the criminal investigation must agree that it will not contradict. Thus, these agreements can provide a road map to further liability, and may leave the corporation little room to defend itself in a later proceeding.

128. See *Stein I, II and III*, discussed *supra* at notes 101-04.

cooperative or contrite. This delicate balancing act requires close scrutiny of the options available to the client and consideration of how current decisions will impact (or limit) the corporation's options many years down the road in parallel government investigations, private litigation, or congressional hearings.