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Deferred Prosecution of Corporations

The Department of Justice has taken a number of steps recently to combat what it sees as overly lenient practices by some federal prosecutors and judges. In the most recent step, Attorney General John Ashcroft made it tougher for federal prosecutors to strike plea bargains with criminal defendants for anything less than a plea to "the most serious, readily provable offense." And three months ago, the attorney general announced a plan to track data on judges who downwardly depart from the federal sentencing guidelines.

While the Justice Department generally is approaching the question of charges, pleas and sentences with unprecedented vigor, one area where more balanced discretion is evident is in the deferred prosecution of corporations. While deferred prosecution (or "pretrial diversion") is not new to the corporate arena, it has become more visible in the wake of recent revisions to the Justice Department's policy on corporate prosecution.

Policy Changes

In January, then-Deputy Attorney General Larry D. Thompson issued the department's revised guidelines for when it will pursue the criminal prosecution of a corporation. The new guidelines[1] have

their origin in a 1999 memorandum issued by Mr. Thompson's predecessor, Eric H. Holder Jr.,[2] entitled "Federal Prosecution of Corporations."

The government's willingness to resolve criminal investigations of corporations with deferred prosecution or non-prosecution agreements makes sense for the government, for corporate entities, and for the public at large.

The Holder Memorandum set forth the general policy that corporations "should not be treated leniently because of their artificial nature" and noted that the prosecution of corporations can result in "great benefits for law enforcement and the public, particularly in the area of white collar crime." The Thompson Memorandum is similar to the Holder Memorandum, with a few key differences, one of which has explicitly opened the door to the use of deferred prosecution agreements in cases of corporate crime.

A main focus of the Thompson Memo's revision of corporate prosecution policy is its increased emphasis on and scrutiny of the authenticity of a corporation's cooperation with law enforcement. In addition, the memo seeks to address the efficacy of corporate governance mechanisms "to ensure that these measures are truly effective rather than mere paper programs."

In keeping with these twin objectives, the explicit recognition of pretrial diversion as an option for corporations may be viewed as a nod to those business entities that demonstrate a serious commitment to implementing appropriate corporate governance and compliance measures to prevent or discourage corporate wrongdoing or to get to the bottom of it when it occurs.

In a typical deferred prosecution agreement, a criminal charge is filed and the defendant, in the agreement, acknowledges and takes responsibility for criminal wrongdoing. Prosecution is then deferred for some period of time, after which, assuming the defendant has complied with the terms of the agreement and has not engaged in additional misconduct, the criminal charge is dismissed with prejudice. If the defendant fails to comply or engages in additional wrongdoing during the deferral period, the case can go to trial with the acknowledgement of wrongdoing used against the defendant.

Deferred prosecution agreements are

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not new to the corporate arena. For example, in 1994 Prudential Securities entered into such an agreement in order to resolve criminal charges that the firm had defrauded investors in the sale of energy limited partnerships.[3] In addition, there was discussion last spring of the possibility of such an agreement in connection with Arthur Andersen's role in the Enron matter, although an agreement was never reached and Andersen was ultimately found guilty at trial of obstruction of justice.[4]

In recent months, however, corporate deferred prosecution agreements are appearing with increased visibility. For example, the Thompson Memorandum was issued in close proximity to a significant deferred prosecution agreement involving Banco Popular de Puerto Rico. Since then, the Justice Department has entered into a deferred prosecution agreement with a subsidiary of PNC Bank and a non-prosecution agreement with Merrill Lynch, perhaps suggesting that we may see more inquiries into corporate wrongdoing resolved in this manner in the future.

Banco Popular

Banco Popular was investigated in connection with its failure to file accurate and timely Suspicious Activity Reports (SARs) over a five-year period. Under the Bank Secrecy Act, banks are required to have comprehensive anti-money laundering programs that enable them to identify and report suspicious financial transactions to the U.S. Treasury Department's Financial Crimes Enforcement Network (FINCEN).

As part of their anti-money laundering programs, banks must report suspicious activity through the filing of SARs. Certain Banco Popular accounts were involved in several suspicious transactions between June 1995 and June 2000, and although the bank did file SARs for these accounts, they were untimely or, in some cases, inaccurate.

In one series of transactions, Banco Popular failed to timely and accurately report suspicious activity in connection with the deposit of approximately $20 million in cash into an account over a three-year period, during which time deposits often were made in paper bags filled with small-denomination bills. The investigation into Banco Popular revealed that millions of dollars in drug proceeds were laundered through the bank over a period of several years.

In January 2003, the bank acknowledged and accepted responsibility for its behavior and agreed to forfeit $21.6 million in satisfaction of all federal claims, including an extant $20 million civil penalty from FINCEN in connection with violations of the Bank Secrecy Act.[5] In exchange, the government agreed to dismiss the criminal charge against the bank with prejudice if it complies with its reporting and financial obligations for the next 12 months.

PNC

In June 2003, PNC ICLC Corp. (PNC), a non-bank subsidiary of the PNC Financial Services Group, Inc., of Pittsburgh, was charged with fraudulently transferring $762 million in mostly-troubled loans and venture capital investments from PNC's balance sheet to certain off-balance sheet, special purpose entities (SPEs).[6] These SPEs were created by PNC and a large insurance company.

In each of the first, second and third quarters of 2001, PNC entered into an SPE transaction in connection with efforts to manage balance sheet volatility and to improve the quality of its on-balance sheet assets. PNC's failure to consolidate these SPE entities on its balance sheet was in violation of GAAP requirements because the SPE's independent third-party owner did not make or maintain a substantive capital investment in the SPE and did not retain the substantive risks and rewards of ownership of the SPE.

PNC's conduct resulted in materially overstated earnings and materially understated losses. Following PNC's restatement and consolidation of the SPE entities onto its balance sheet on Jan. 29, 2002 (resulting in a $155 million reduction in net income and a $125 million increase in non-performing assets), PNC's stock price dropped by more than 9 percent.

In a deferred prosecution agreement executed in June 2003, PNC agreed to pay $90 million to a victim restitution fund and $25 million in penalties to the United States. PNC also acknowledged responsibility for its conduct and pledged its complete cooperation with a continuing investigation into the SPE transactions.

The government agreed to defer prosecution of the criminal complaint for 12 months and eventually to seek dismissal of the complaint with prejudice if PNC fully complies with its obligations under the agreement.

According to the comments of Mr. Thompson at the time, "the continued cooperation of corporate wrongdoers is an essential part of 'real time' fraud enforcement."[7]

Mr. Thompson explained that the PNC deferred prosecution agreement "strikes a balance between our commitments to rooting out corporate corruption and securing the assistance we need to conduct swift and thorough investigations."

The government explained that the deferred prosecution agreement was justified by the extensive remedial actions taken by PNC in response to the investigation — including the addition of new board members and managers, the strengthening of the company's code of ethics, and the adoption of comprehensive policies and procedures in the areas of corporate governance, risk management and regulatory relations — and its continued cooperation in the government's criminal investigation of others.

Merrill Lynch

Merrill Lynch and the Justice Department recently reached an even more corporate-favorable result — a non-prosecution agreement — arising out of the government's investigation of cer-

tain transactions entered into by Enron and Merrill Lynch at the end of 1999.[8]

One of these transactions was an alleged asset parking transaction which permitted Enron to enhance its earnings figures for the 1999 fiscal year. Enron secured Merrill Lynch's agreement to purchase Enron's interest in electricity-generating power barges moored off the coast of Nigeria so Enron could record $12 million in earnings and $28 million in cash flow at year-end.

However, the government alleged that Merrill Lynch employees were aware from the transaction's inception that Enron would repurchase the barges or sell them to a third party within six months and would pay Merrill Lynch a 22 percent return on the transaction. These agreements, which were not disclosed to Enron's accountants, meant that the transaction did not qualify as a sale from which Enron could legitimately record earnings and cash flow.

In an agreement made public two weeks ago, Merrill Lynch accepted responsibility for the conduct of its employees, acknowledging that the government "has developed evidence during its investigation that one or more Merrill Lynch employees may have violated federal criminal law."

Merrill Lynch also agreed to cooperate fully with the government's continuing investigation into the demise of Enron and to implement a series of significant reforms addressing the integrity of certain transactions. Among the reforms agreed to by Merrill Lynch are: the creation of a new committee of senior executives to review all complex structured finance transactions; the completion of written reports in connection with all reviewed transactions to be provided to the counterparty's independent auditor; and the development of a comprehensive training program for all personnel that highlights factors in a transaction that would warrant additional scrutiny.

As part of its new transaction review policy, Merrill Lynch also promised not to engage in business deals that help companies mislead investors about their financial condition. Specifically, Merrill Lynch agreed to not enter into transactions that have terms that are not reflected in transaction documentation, transactions that are offsetting or transactions in which the parties have agreed in advance on an early termination. The agreement further provides that an independent monitor, along with an outside auditing firm, will monitor Merrill Lynch's compliance with these new reforms for a period of 18 months.

In exchange, the government has agreed not to prosecute Merrill Lynch for any crimes relating to the year-end Enron transactions. Merrill Lynch has agreed that, if it violates the terms of the agreement, the government can prosecute the company for any crimes committed by its employees in connection with the transactions. Because the agreement was a non-prosecution rather than a deferred prosecution agreement, it does not state that prosecution will be deferred for a specific period of time. Instead, it contains an expiration date of June 30, 2005.

Conclusion

The government's willingness to resolve criminal investigations of corporations with deferred prosecution or non-prosecution agreements makes sense for the government, for corporate entities, and for the public at large.

These agreements do not go easy on corporate offenders. As the above examples demonstrate, they often extract significant monetary penalties, require fundamental changes in the way business is done with an eye toward avoiding criminal violations in the future, and require corporations to acknowledge and take responsibility for criminal conduct that has occurred.

As the Thompson Memorandum observes, "[i]n the corporate context, punishment and deterrence are generally accomplished by substantial fines, mandatory restitution, and institution of appropriate compliance measures."[9]

Deferred prosecution agreements accomplish these objectives without the collateral consequences to business operations and innocent personnel that often result from a criminal conviction. Because of the emphasis these agreements place on corporate governance and business practices, they also may be a more effective means of bringing about long-term change in corporate behavior.

The Justice Department's recent willingness to enter into deferred, or non-prosecution, agreements thus has all the earmarks of a worthy trend.

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(1) See www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00162.

(2) Mr. Holder is now a partner of the author.

(3) S. Walsh & J. Mathews, "Prudential Accused of Fraud, Gets Chance to Avoid Trial," The Washington Post, Oct. 28, 1994. In exchange for a deferral of prosecution for three years, Prudential admitted wrongdoing and paid $330 million into a special fund for investors.

(4) K. Eichenwald, "Andersen to Admit Crime for Settlement," The New York Times, April 11, 2002; D. Ackman, "Andersen Plea: Maybe Guilty, It Depends," Forbes.com, April 11, 2002.

(5) See DOJ Press Release, "Banco Popular de Puerto Rico Enters Into Deferred Prosecution Agreement with U.S. Department of Justice," Jan. 16, 2003 (available at www.usdoj.gov/opa/pr/2003/January/03_crm _024.htm).

(6) See PNC Form 8-K filed on June 2, 2003, Exhibit A (Statement of Facts) (available at www.sec.gov/Archives/edgar/data). These transactions also were the subject of a July 2002 consent order between PNC and the SEC and the subject of a separate agreement between PNC and the Federal Reserve.

(7) See DOJ Press Release, "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).

(8) See DOJ Press Release, "Merrill Lynch Agrees To Cooperate With Enron Investigation, Implement Reforms, With Oversight By Monitor," Sept. 17, 2003 (available at www.us-doj.gov/opa/pr/2003/September/03_crm_510.htm).

(9) See Thompson Memo, XII(B), second paragraph.