PROGRAM MATERIALS
Program #1840
June 23, 2008

The SEC and Self-Reporting and Cooperation: Key Issues

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THE SEC, SELF-REPORTING AND COOPERATION: KEY ISSUE

By: Thomas O. Gorman[1]

I. Introduction

A. The Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ") have long encouraged business organizations to self-report conduct which may be a violation of law. When business organizations self-report and remediate a possible malfeasance, it not only conserves scarce governmental resources, but also informs law enforcement of an incident that might have gone undetected.

1. In some instances, there may be a legal requirement to self-report. In others, there are strong legal incentives which some commentators suggest may constitute a duty to self-report, remediate and cooperate.

2. Some commentators argue that as a good corporate citizen, a business organization discovering potentially wrongful conduct should self-report and remediate the matter regardless of legal obligation or incentives offered by law enforcement.

3. To encourage business organizations to self-report, both the SEC and DOJ offer the prospect of amnesty or at least lesser sanctions than might otherwise be imposed.

B. Business organizations considering whether to self-report face a daunting set of frequently conflicting choices, some of which may undercut their altruistic good citizen goal of cooperating with law enforcement and some of which may potentially harm the business.

1. In part, these situations arise from being entangled in a violation of the law by its agents.

2. In part, they stem from the conflicting positions and goals of law enforcement which wants to:

a. Maintain its prosecutorial discretion;

b. Tends to view anything less than what it deems to be full and complete disclosure of the facts, including those to which it is not

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entitled because of privilege or which may not be accessible to the organization because of positions asserted by its agents, as a lack of cooperation or worse; and

c. Wants to send a strong "tough cop" message to the market in every case.

C. ***The question of self-reporting:*** To consider this issue, the following points will be analyzed:

1. The legal framework of self-reporting, including SEC and DOJ positions on self-reporting and cooperation;

2. Conflicting law enforcement positions on cooperation; and

3. Conclusions.

II. Self-Reporting: The Legal Framework

A. ***The obligation to self-report***.: In some instances, a business organization may have an obligation to self-report.

1. Section 10A(3) of the Securities Exchange Act of 1934 ("Exchange Act") requires that after receiving a report from its auditor under Section 10A(2) of illegal acts, the issuer "shall inform the Commission by notice not later than 1 business day after the receipt of such report … ."

2. In some instances, corrective disclosures may be required such as where the financial statements have a material error. *See, e.g.,* SFAS 154, Accounting Changes and Error Corrections.

B. ***Incentives to self-report – Law Enforcement***. The SEC and DOJ have long offered business organizations incentives to self-report and cooperate.

1. The SEC in the *Seaboard* Release[2] encourages issuers to self-report. The agency offers business organizations the prospect of cooperation credit, that is, the possibility of favorable consideration in the charging process in return for cooperation with its inquiry.

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[2] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act and Commission on the Relationship of Cooperation and Agency Decisions, Securities Exchange Act of 1934 Release No. 44969 (Oct. 23, 2001) ("*Seaboard* Release"), available at www.sec.gov/litigation/investreport 134-44969.htm. This is a report of an investigation of a corporate financial fraud. In the Report, the SEC summarizes certain principles which guide its charging decisions as to business organizations. It also discusses credit in that decision-making process in return for corporate self-reporting and cooperation.

2. The Department of Justice, in the McNulty Memorandum,[3] offers similar incentives.

3. The Federal Sentencing Guidelines for Organizations also provide incentives for business organizations to disclose criminal conduct voluntarily and accept responsibility. Under the Guidelines, which are no longer mandatory, a corporation receives a benefit if it has in place an effective compliance program to prevent and detect violations of law. The benefit from having a compliance program, however, is lost if the organization unreasonably delays reporting an offense to appropriate governmental authorities after becoming aware of criminal conduct. To obtain credit, the disclosure must be before the government discovers the conduct. U.S. Sentencing Guidelines Manual, Section 8C2.5(f) (2005), http://www.ussc.gov/2005guid/tabcon05.htm.

C. ***Incentives to Self-Report: Organizational liability and SOX.*** Principles of organizational liability and obligations imposed by the Sarbanes-Oxley Act of 2002 ("SOX") create a framework which many argue compels self-reporting. Corporate charging principles provide this incentive because of the broad, virtually open-ended liability business organizations face. SOX adds to this by ensuring that corporate managers monitor and certify corporate systems thereby detecting potential malfeasance.

1. Organizational liability.

a. Business organizations are subjected to very broad liability, vesting broad discretion with the prosecutor in the charging process. Since the Supreme Court's decision in *New York Central and H.R.R. v. U.S.,* 212 U.S. 481, 494 (1909), business organizations have been subject to criminal prosecution. Under the Court's decision, a business organization may be held liable for the acts of its agents:

i. If the act is within the scope of the agent's authority and for the benefit of the organization.

[3] Memorandum from Paul J. McNulty, Deputy Att'y Gen., U.S. Dep't of Justice, Principles of Federal Prosecution of Business Organizations (Dec. 12, 2006), ("McNulty Memorandum"), http://www.usdoj.gov/dag/speeches/2006/mcnulty-memo.pdf. This memorandum is one of a series of memoranda on this topic the first of which was written by Deputy Attorney General Eric Holder. Memorandum from Eric Holder, Deputy Attorney General to All Component Heads and United States Attorneys, Bringing Criminal Charges Against Corporations (June 16, 1999) ("Holder Memorandum"), http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html. Mr. Holder's memo was superseded by one prepared by Larry Thompson. Larry D. Thompson, Deputy Att'y Gen., U.S. Dep't of Justice, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), ("Thompson Memorandum") http://www.usdoj.gov/dag/cftf/corporate-guidelines.htm.

ii. The benefit from the agent's acts need not be exclusively for the organization. Rather, it is sufficient that the organization derive some benefit, even though most of it flows to the agent. *See, e.g., U.S. v. Automated Medical Laboratories,* 770 F.2d 399 (4th Cir. 1985); *but see U.S. v. Cincotta,* 689 F.2d 238 (1st Cir. 1982), *cert. denied,* 455 U.S. 991 (1982) (corporation not liable when employee's intent is to solely benefit himself and could not benefit the stock holders).

b. The basic principles for imposing organizational liability in criminal cases from the actions of employees also apply in SEC enforcement cases, giving enforcement officials broad latitude when making a charging decision. *See, e.g., SEC v. J.W. Barclay & Co., Inc.*, 442 F.3d 834, 844 (3d Cir. 2006) (SEC may impose liability on an organization for insider trading violations by employees.).

2. SOX: The Act imposes specific monitoring and reporting obligations on business organizations and corporate managers which provide, at a minimum, strong incentives to self-report.[4] By imposing monitoring, reporting and attestation obligations on management, directors, the auditors and counsel, SOX effectively requires the creation of systems for the detection of malfeasance, an obligation to search out such conduct and, arguably a duty to self-report such conduct.[5]

a. Sections 302, 906 and 404 impose obligations on members of management, in part backed by a certification by the outside auditors, which effectively require that there be information systems in place to ensure that all material information is known to it.

i. Section 302 requires that the principal executive officer and principal financial officer certify in periodic, filed reports:

(a) That they have reviewed the periodic report being filed and that, to the signing officer's knowledge,

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[4] The basic obligations of directors are bolstered by the SOX monitoring obligations. *See, e.g.*, *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) (discussing the obligations of directors to monitor and their reliance on corporate systems). *See also*, *In re The Walt Disney Company Derivative Litigation*, 906 A.2d 27 (2006) (discussing duties of directors).

[5] *See, e.g.,* Thomas O. Gorman & Heather J. Stewart, *Is There a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants and Lawyers After Sarbanes-Oxley of 2002*, 56 ADM. L. REV. 135 (2004); *see also* Robert S. Bennett, Alan Kreegel, Carl S. Rauh and Charles F. Walker, *Internal Investigations at the Defense of Corporations in the Sarbanes-Oxley Rev.*, 62 Bus. Law 55 (Nov. 2006) ("whenever a company has reason to believe that a problem may have occurred, it should investigate internally. … Although the company may pause to ask whether it really wants to know what happened, the answer is that it can not afford not to know, particularly given the certification obligations … ." under SOX) ("Bennett").

the report does not contain any material untrue facts or omissions and that the financial statements and data fairly present in all material respects the financial condition of the issuer;

(b) That they have established and maintained internal controls which assure that all material information has been made known to them; and

(c) That they have disclosed to the auditors and the audit committee all significant deficiencies in the design or operation of internal controls and any fraud regardless of materiality which involves management or other employees who have a significant role in the issuer's internals controls.

ii. Section 906 fortifies the obligations of Section 302 and adds criminal penalties. In addition, the Section requires that the chief executive officer and chief financial officer provide a written statement certifying that the periodic reports which contain the financial statements fully comply with the applicable sections of the Exchange Act and that the information furnished fairly presents in all material respects the financial condition and results of operations of the company.

iii. Section 404(a) requires that each annual report contain an internal control report. The internal control report states that management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting and an assessment of the effectiveness of those controls. This certification is confirmed by the outside auditors.

b. Section 301 deals with the audit committee, which traditionally monitors financial and related matters for the organization. Under Section 301, the audit committee, which is composed of independent directors and must have a financial expert per Section 407, not only appoints the outside auditors, but also receives and reviews:

i. The Section 302 reports of management;

ii. A report from the outside auditors on all:

(a) critical accounting policies;

(b) alternative accounting treatments discussed between the auditors and management;

(c) their effects and which ones the auditors prefer; and

(d) all written communications between the auditors and management; and

iii. Complaints from a procedure established by the committee which permits it to obtain complaints regarding accounting procedures and confidential information on these subjects from employees.

iv. Section 301 also empowers the audit committee to engage independent counsel and other advisors to assist with its monitoring function and requires the issuer to provide an appropriate budget.[6]

c. Corporate counsel serves as an additional monitor.

i. Section 307 requires counsel to report up the ladder to the chief legal officer and ultimately to the audit committee all material violations of law, breaches of fiduciary duty or similar violations.

ii. The SEC has also adopted rules under this section which implement the obligations of attorneys to report up the ladder. Those rules, under limited circumstances, authorize counsel to disclose confidential information without the consent of the client.[7] The SEC deferred action on a controversial proposed "noisy withdrawal" rule that would have required counsel to notify the Commission upon receipt of an inadequate response after reporting up the ladder. Sarbanes-Oxley Act of 2002, 17 C.F.R. § 205.3 (2003); *see also* C. Evan Stewart, *The Pit, the Pendulum, and the Legal Profession: Where Do We Stand After Five Years of Sarbanes-Oxley?*, 40 SEC. REG. & L. R. 247 (Feb. 18, 2008) (discussing actions against counsel).

D. Collectively these principles:

1. At a minimum, impose significant pressure on any business organization to self-report and cooperate, particularly in view of the breadth of potential liability and the potential draconian consequences to the business.

2. According to some commentators, effectively compel self-reporting:

[6] As one commentator noted: "The audit committee in these investigations is charged with oversight and responsibility for all aspects of the investigation, including its initial conduct and ultimately, the decision whether when it has to report it to the government and/or shareholders." Bennett at 7.

[7] Although the rules state that they do not preempt state ethics rules, North Carolina and the State of Washington have taken a contrary view. N.C. RULES OF PROFESSIONAL CONDUCT R. 1.6 and 1.13; Memorandum from Washington State Bar Ass'n Ethics Committee, Background on Proposed Interim Formal Ethics Opinion Re The Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorneys' Obligations under the RPCs (July 2003), http://www.wsba.org/lawyers/groups/ethics2003/sarbanesoxleymemotoboadofgovernors.doc.

> Under current federal law and Department of Justice Policy, it would be irresponsible for management to attempt to defend the corporation or its employees.[8]

3. In view of the substantial pressure placed on a business organization and its leaders, it is difficult to view self-reporting as anything but an involuntary act.[9]

III. Conflicting Pressures Undercutting Incentives to Self-Report and Cooperate

A. ***The decision.*** Business organizations considering the question of self-reporting face conflicting legal and business considerations. While the organization may want to cooperate with law enforcement and expeditiously resolve the matter, the expectations of law enforcement officials and the practical legal and business issues which must be resolved may preclude or impede achieving this goal.

B. ***The charging decision.*** The question of self-reporting and the related issue of cooperation credit is keyed to the charging decision. Credit for self-reporting and cooperation is given by the SEC or DOJ as part of the overall charging process. As *New York Central* demonstrates, prosecutors have wide, virtually limitless discretion in making a charging decision.

1. The SEC has outlined factors which it considers in the charging process in the *Seaboard* Release. The Release lists thirteen groups of questions to be considered in making a charging decision. Three considerations are singled out in the Release as being critical:

   a. The overriding issue in every enforcement judgment, according to the Release, is what best protects investors. The Commission expanded on this notion stating: "There is no single, or constant, answer to that question [of investor protection]. Self-policing, self-reporting, remediation and cooperation with law enforcement authorities, among other things, are unquestionably important. … But, so too are vigorous enforcement and the imposition of appropriate sanctions where the law has been violated." *Seaboard* Release at 2.

   b. The factors listed in the Release do not in any way limit the discretion of the agency: "we are not adopting any rule or making any commitment or promise about any specific case; nor are we in

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[8] John Hasnas, *Department of Coercion*, Wall St. J., March 11, 2006; *See also* Frank C. Razzano, *To Cooperate With the Securities and Exchange Commission or Not to Cooperate – That is the Question – Part II*, 31 SEC. R. L. J. 410 (2003).

[9] *See generally Johnson v. Zerbst*, 304 U.S. 458 (1938) (discussing voluntary waiver as an intentional relinquishment of a known right).

any way limiting our broad discretion to evaluate every case individually … ." *Id.*

c. The criteria discussed in the Release are not exclusive: "we do not limit ourselves to the criteria we discuss below [the thirteen categories]. By definition, enforcement judgments are just that – judgments. Our failure to mention a specific criterion in one context does not preclude us from relying on that criterion in another. Further, the fact that a company has satisfied all the criteria we list below will not foreclose us from bringing enforcement proceedings that we believe are necessary or appropriate … ." *Id.*

2. Overall, the *Seaboard* Release makes it clear that enforcement decisions are made on a case-by-case basis, on factors which may or may not appear in it as the SEC determines in its discretion.

3. DOJ takes a similar approach. In the McNulty Memorandum and its predecessors, the Department has articulated nine key factors, amplified by commentary, which guide its charging discretion. Like *Seaboard*, the McNulty Memorandum makes it clear that the criteria listed are not exclusive and do not delimit the Department's discretion. McNulty Memorandum at 4.[10]

C. ***Cooperation credit standards.*** The SEC and DOJ offer the prospect of cooperation credit in *Seaboard* and McNulty. Little concrete guidance is offered, however. Rather, the statements are, like the entire charging process, vague, open-ended and ill-defined. Stated differently, what constitutes cooperation and how much credit, if any, will be awarded is totally within the discretion of law enforcement officials. Business organizations that want to cooperate essentially must guess what is expected and required.

1. ***Seaboard.*** The *Seaboard* Release discusses the question of self-reporting and cooperation. The key portion of the Release on cooperation is the first section which gives an example of a company given cooperation credit. In the example, the company discovered a financial fraud and self-reported. The SEC elected not to bring an enforcement action based on what it called the "nature of the conduct and the company's response." *Seaboard*

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[10] As former Attorney General Edwin Meese, III told Congress about the charging and cooperation factors in the Thompson Memorandum: "Companies reasonably consider each of the Thompson memorandum factors mandatory. Given the Thompson memos indefiniteness about how the government will weigh its nine factors and the examples provided for, each, in my judgment, corporate counsel -mail would be irresponsible to advise their clients otherwise." *The Thompson Memorandum's Effect on the Right to Counsel in Corporate Investigations Before the S. Comm. On the Judiciary*, 108th Cong. 4 (2006) (statement of Edwin Meese, III, The Heritage Foundation), available at http://judiciary.senate.gov/testimony.cfm?id=2054&wit_id=5741. The same basic principles are in the McNulty Memorandum

Release at 1. The SEC identified the following factors as factors considered in deciding not to charge the company:

a. The conduct was a limited financial fraud discovered in a subsidiary;

b. Within one week of the discovery, the internal auditors had conducted a preliminary review and advised management who informed the audit committee;

c. The board was advised and outside counsel was retained;

d. Eleven days after discovery, the person deemed responsible was dismissed along with two other employees who had not adequately supervised the responsible person;

e. Twelve days after discovery, the company self-reported to the SEC and issued a press release noting that a restatement was necessary. The share price did not decline;

f. The company pledged and gave cooperation to the staff;

g. The company furnished the staff with all information relevant to the violations including details from its investigation, such as notes and transcripts of interviews of the responsible person and others;

h. The company did not invoke the attorney-client privilege, work product protection or other privileges or protections "with respect to any facts uncovered in the investigation." *Id.*

i. The company strengthened its financial reporting process to address the specific conduct involved.

2. ***DOJ.*** As part of the charging process, credit may be given for cooperation. While DOJ's memos do not contain a specific example like the *Seaboard* Release, they do discuss the concept in broad terms, noting that in some instances, immunity or amnesty or pretrial diversion might be considered. Key to this process is self-reporting, conducting an internal investigation, and furnishing the complete results of that inquiry to the government. These factors, however, do not limit DOJ's charging discretion. McNulty Memorandum at 2.

D. ***The application of the standards.*** The broad discretion given prosecutors under *New York Central*, and the frequently drastic impact of a charging decision on a business organization coupled with the obligations imposed by SOX, arguably creates for the business organization discovering a possible malfeasance a duty to self-report – or, at a minimum, extreme pressure to do so – and leaves the company at the mercy of law enforcement officials. At the same time, what must

be done to cooperate is far from clear. Likewise, while there may be benefits, what can be expected is far from clear.[11]

1. ***SEC's notion of cooperation.*** Examination of SEC settlements does not reveal a discernable pattern which would provide guidance to those confronting a decision regarding self-reporting and cooperation. Four examples of settled financial fraud cases from last year illustrate this point. Each case involved is a significant financial fraud, typically based on years-old conduct. In two cases, the SEC acknowledged cooperation. In two, it did not.

   a. In *SEC v. The BISYS Group, Inc.*, Civ. Action No. 07-4010 (S.D.N.Y. filed May 23, 2007), the Commission filed a settled financial fraud case and acknowledged in its press release "extensive cooperation during the investigation."

i. The complaint alleged a financial fraud over a period of years which a senior SEC staff member called "a case study in internal control failures under earnings pressure.'" Press Release, Securities and Exchange Comm'n, BISYS to Pay $25 Million to Settle Financial Reporting and Related Charges by SEC (May 23, 2007), available at http://www.sec.gov/ news/ press/ 2007/2007-100.htm.

ii. According to the complaint, from 2000 through 2003, the company employed a variety of improper accounting practices which overstated income by about $180 million to meet Wall Street estimates.

iii. The company also received about $20 million in ill-gotten gains from its issuance of convertible debt, stock, and options at prices that were inflated as a result of its violations.

iv. As a result, the company restated its financial statements twice demonstrating that pretax income was overstated by 34.3%, 38.9% and 20.6% for fiscal years 2001-2003. The employees involved are no longer with the company.

v. To settle, the company consented to an injunction prohibiting future violations of the books and records provisions and an order requiring the payment of disgorgement and prejudgment interest of $25 million.

[11] As one commentator noted: "Corporations, unlike most entities, will take a hard look at the bottom line and often decide that whether or not their point is contestable, they have no choice but to cooperate fully with the government in hopes of avoiding the general train wreck of a conviction. This dynamic is reinforced by the incentives recent legislation and developments in corporate law have created for corporate boards – and particularly, the increasingly powerful independent directors in the post-Enron era – to protect themselves against civil liability by rolling over whenever prosecutors come calling." Julie R. O'Sullivan, *The Last Straw: The Department of Justice's Privilege Waiver Policy and the Death of Adversarial Justice in Criminal Investigations of Corporations*, 57 DEPAUL L. REV. 329, 340 (2008).

b. *SEC v. Nortel Networks Corp.,* Civ. Action No. 07-CV-8851 (S.D.N.Y. filed Oct. 15, 2007), is a financial fraud case in which the SEC described the cooperation as "significant."

i. The complaint alleged that the company improperly accelerated the recognition of revenue to meet earnings targets from 2000-2001. In 2002, the company improperly established and maintained reserves.

ii. The complaint alleged two basic schemes. In the first, it altered its revenue-recognition policies to accelerate into 2000 revenues as needed to meet guidance and cover a deteriorating financial condition. In the second, it established improper reserves and used those to improperly adjust its income as the company returned to profitability.

iii. The company had two restatements. The first was essentially a sham, which led to an internal investigation. The second restated approximately $3.4 billion in misstated revenues and at least another $746 million in liabilities for fiscal year 2001 and 2002 and the first, second and third quarters of 2003. The employees involved are no longer with the company.

iv. To settle, the company consented to the entry of a permanent injunction prohibiting future violations of the antifraud and reporting provisions and an order requiring the payment of a $35 million penalty.

c. *SEC v. Federal Home Loan Mortgage Corp.,* Civ. Action No. 07-CV-1728 (D.D.C. filed Sep. 27, 2007), is a settled financial fraud case in which the SEC did not acknowledge cooperation:

i. The complaint alleged that from 2000 to 2002, the company improperly smoothed earnings trends thereby misreporting income.

ii. The improper conduct emanated from a culture which emphasized steady earnings, not compliance.

iii. The company restated its financial statements for 2000, 2001 and 2002. According to that restatement, the company misreported its net income by, respectively, 30.5%, 23.8% and 42.9%. Had the company properly reported income, its earnings would have decreased by over $500 million between 2000 and 2001. The company also underreported its 2002 net income by more than $4 billion.

iv. The executives involved in these transactions and named in the complaint are no longer employed by the company.

v. To settle, the company consented to the entry of a permanent injunction prohibiting future violations of the antifraud provisions and an order requiring the payment of a $50 million penalty.

d. *SEC v. ConAgra Foods, Inc.,* Civ. Action No. 07-cv-0157 (D. Col. filed Jul. 25, 2007), is a settled financial fraud case in which the Commission did not acknowledge cooperation.

i. The complaint alleged a misuse of reserves, which in some instances was fraudulent, to manipulate reported earnings and a scheme at a subsidiary to prematurely recognize income for fiscal years 1999 through 2001. In addition, for fiscal years 2002 and 2005, the company made numerous tax errors which resulted in improper accounting for tax benefits and understating its income tax expense.

ii. Absent the improper and, at times fraudulent, accounting practices, the company would have missed Wall Street consensus estimates for at least six of eleven fiscal quarters in 1999, 2000 and 2001.

iii. A related administrative proceeding was brought against six employees, four of whom are no longer with the company and two of whom are acting as consultants to the company.

iv. To resolve this action, ConAgra consented to the entry of a permanent injunction prohibiting future violations of the antifraud and books and records provisions of the securities laws and an order requiring that it pay a $45 million penalty. The company also agreed to a review by an independent consultant of its policies and procedures and financial and accounting compliance functions with respect to certain reserve accounts.

2. Examination of these cases suggest that there is some benefit to cooperation.

a. None of these companies avoided prosecution, the prospect raised by the *Seaboard* Release. However, the fraud at the company in *Seaboard* was limited and confined to a subsidiary, while in the four cases cited above, the misconduct was much more extensive. Since *Seaboard* notes that the conduct may influence cooperation credit, this may account for the difference.

b. In *Seaboard*, the company waived privilege. It could not be determined in the examples above whether privilege had been waived.

c. Each of the companies in the cases cited above consented to permanent injunctions. Both Federal National Mortgage and ConAgra, who were not cited for cooperation, consented to fraud injunctions, as did Nortel, despite the SEC's acknowledgement of significant cooperation. Only BISYS avoided a fraud injunction. The reason for the difference is not readily discernable from reviewing the papers made available by the SEC.

d. Three of the four companies paid substantial fines while only one paid disgorgement. Federal National Mortgage paid the largest penalty at $50 million, ConAgra the second largest at $45 million, with Nortel receiving the smallest penalty at $35 million. In contrast, BISYS did not pay any penalty, but did pay $25 million in disgorgement and prejudgment interest. Interestingly, ConAgra is the only company at which employees claimed by the SEC to have been involved remained with the company. These results suggest that cooperation may have impacted the amount of the penalty. Nevertheless, Nortel clearly paid a substantial penalty, despite its cooperation.

e. In sum, these cases suggest:

i. Cooperation may not lead to amnesty unless the conduct is limited;

ii. Cooperation has some benefits and may result in a less draconian injunction and fine; and

iii. What is expected as cooperation, and can be expected in return, is far from clear.

E. ***Other key considerations.*** In deciding whether to self-report and cooperate, the benefits for those acts must be balanced against the costs. Three key questions which should be evaluated concern privilege, contribution and indemnification, and cooperation with employees and former employees.

F. ***Privilege*:** Business organizations can assert the attorney-client privilege in response to requests by law for conflict for information. *See Upjohn Co. v. United States*, 449 U.S. 383 (1981).

1. Corporations can be compelled by the government to report their questionable or potentially illegal conduct. They do not have Fifth Amendment protections. *See Hale v. Henkel*, 201 U.S. 43, 70 (1906).

2. In contrast, individuals cannot be compelled to testify against themselves. *Ohio v. Reiner*, 532 U.S. 17, 21 (2001) (per curiam) (" … we have emphasized that one of the Fifth Amendment's basic functions … is to protect *innocent* men … who otherwise might be ensnared by ambiguous circumstances. [We have] recognized that truthful responses of an innocent witness, as well as those of a wrongdoer, may provide the government with incriminating evidence from the speaker's own mouth.") (internal quotations omitted).

3. Privileges such as the attorney-client privilege and the work product doctrine are the only real protections of business organizations.[12] Undercutting confidence on these privileges can discourage organizations from seeking advice and thus undercut compliance. *Upjohn v. United States*, 449 U.S. 383 (1981).

4. Both *Seaboard* and McNulty discuss the question of privilege waivers. Neither requires a waiver of privilege as a precondition of cooperation or to obtain cooperation credit.[13]

   a. A host of critics including the American Bar Association, The Business Roundtable and other business and trade organizations as well as former Attorneys General and others have criticized SEC and DOJ policies on privilege waivers.[14]

i. Essentially, these critics claim that SEC attorneys and DOJ prosecutors are creating a "culture of waiver" which unnecessarily strips and injures business organizations and their employees of their rights.[15]

ii. One court held a portion of DOJ's policies in the predecessor to the McNulty Memorandum unconstitutional. *U.S. v. Stein,* 435 F. Supp. 2d 330 (S.D.N.Y. 2007) (holding that provisions of the Thompson Memorandum violated the right to

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[12] Julie R. O'Sullivan, *supra* note 10, at 340 (2008) ("corporations, cannot claim the Fifth Amendment right against self-incrimination. The attorney-client privilege and the work-product doctrine are critical … because they serve as a substitute for the Fifth Amendment … .").

[13] There are layers of privilege which must be considered in evaluating the question of cooperation and waiver. Typically, the audit committee or board will have retained an independent law firm to conduct an investigation of the matter. (The discussion in the text assumes this has been done.) One layer of privilege involves the internal investigation and work product of the lawyers involved. Included here are discussions and notes from interviews with various witnesses. A second layer of privilege may involve lawyers for the company who advised the issuer during the events which are now the subject of the inquiry. A third layer may involve counsel advising the company during the inquiry. The text focuses on layer number one since it is the only one mentioned in *Seaboard* in the example of cooperation. *Seaboard* Release, Securities Exchange Act of 1934, Release No. 44969 (Oct. 23, 2001).

[14] U.S. Chamber of Commerce, Report on the Current Enforcement Program of the Securities and Exchange Commission (March 2006), available at http://www.uschamber.com/publications/reports/0603sec.htm ("US Chamber of Commerce Report"); Letter from Karen J. Mathis, President, American Bar Association to The Honorable Christopher Cox, Chairman, SEC (Feb. 5, 2007), available at http://www.abanet.org/poladv/letters/attyclient/2007feb05_privwaivsec_l.pdf.

[15] National Association of Criminal Defense Lawyers News Release, Report: Attorney-Client Privilege Disappearing in White Collar Cases (Mar. 2, 2006), available at http://www.nacdl.org/ public.nsf/newsreleases/2006mn005?OpenDocument; National Association of Criminal Defense Lawyers, The Decline Of the Attorney-Client Privilege in the Corporate Context Survey Results, (Mar. 2, 2006), available at http://www.nacdl.org/public.nsf/whitecollar/wcnews024/$FILE/A-CPrivSurvey.pdf.

counsel of KPMG employees indicted for tax fraud). DOJ revised its standards in the wake of this criticism, issuing the McNulty Memorandum.[16]

b. The SEC

i. The *Seaboard* Release states that the issuer may chose not to assert applicable privileges as part of self-reporting and cooperating with the staff.

(a) The Release suggests that issuers may want to enter into a so-called non-waiver agreement under which privileged materials are produced to the SEC under an agreement which stipulates that the production does not constitute a waiver as to third parties.[17]

(b) The Release does not state that a waiver of privilege is required to obtain cooperation credit. However, in the underlying financial fraud case on which *Seaboard* is based and which is cited as an example at the beginning of the Release, the issuer was not prosecuted based, in part, on its determination not to assert privilege and to provide notes of witness interviews, including those regarding the person responsible for the financial fraud.

ii. The SEC has not modified its position on privilege and waivers despite the storm of protest, specific requests to do so,[18] and even the statement of one Commissioner.[19]

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16 Following a hearing in Congress, The Attorney Client Privilege Protection Act of 2008 was introduced. This legislation precludes federal prosecutors from seeking a waiver of privilege. It does not prevent the company from voluntarily waiving its privileges. It has passed the House and is in the Senate. The Attorney Client Privilege Protection Act of 2008, H.R. 3013, 110th Cong. (2008).

17 The case cited is *In re: Qwest Communications Int'l, Inc., Civ. Action* No. 06-1070 (10th Cir. filed Jun. 19, 2006). There, as in other cases, the SEC argued in support of its non-waiver agreement theory. Under that theory, a company can produce privileged documents to the SEC pursuant to an agreement which provides that production is not a waiver. The court in *Qwest* rejected the SEC's position as have most courts. *See, e.g., Westinghouse Elec. Corp. v. Republic of the Phil.*, 951 F. 2d 1414, 1422 (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); *but see Diversified Ind. Inc. v. Meredith,* 572 F.2d 596 (8th Cir. 1977) (adopting SEC's theory). Congress has rejected the SEC's efforts to pass legislation on this point. *See, e.g.,* 16 Sec. Reg. & L. Rep. (BNA) 460 (March 2, 1984) (SEC sponsored proposed legislation on limited waiver); *see also* Securities Fraud Deterrence and Investigation Restitution Act, H.R. 2179, 108th Cong. (May 21, 2003). Likewise, the Rules Committee for the Federal Rules of Evidence dropped a proposed amendment to Evidence Rule 502 which incorporated a "selective waiver" provision, a variation of the SEC's non-waiver agreement. S. REP. NO. 110-264, at 4 (2008).

18 Letter from Karen J. Mathis, President, American Bar Association to The Honorable Christopher Cox, Chairman, SEC (Feb. 5, 2007), http://www.abanet.org/poladv/letters/attyclient/2007feb05 privwaivsecl.pdf.

19 Paul S. Atkins, Speech by SEC Commissioner: Remarks at the Federalist Society Lawyers' Chapter of Dallas, Texas (Jan. 18, 2008), http://www.sec.gov/news/speech/2008/spch011808psa.htm.

The staff has continued to state that privilege waivers are not a necessary to obtaining cooperation credit.

iii. In a 2007 speech,[20] the Director of the SEC's Enforcement Division gave two examples of cooperation as illustrations of the Commission's approach to cooperation credit. In one example, the company waived privilege. In the other, it did not. The company which waived privilege was not prosecuted. The company which did not waive privilege was prosecuted but, presumably, obtained credit for its cooperation by obtaining less punitive treatment from the SEC.

20 Linda Thomsen, Speech by SEC Staff: Remarks Before the Mutual Fund Directors Forum 7th Annual Policy Conference (Apr. 12, 2007), http://www.sec.gov/news/speech/2007/spch041207 lct.htm.

c. DOJ

i. The McNulty Memorandum, prepared as a response to critics of government policies on organizational cooperation and privilege, significantly changes the tone of the discussion by replacing skepticism toward offers of cooperation with respect for the key role of privilege. The memo limits the circumstances under which prosecutors can request a waiver of corporate privilege, specifying that they can only seek a waiver in two limited instances and under certain procedural safeguards. The memo notes, however, that issuers may voluntarily waive privilege and receive cooperation credit.

ii. A survey conducted by E. Norman Veasey, former Chief Justice of the Delaware Supreme Court, suggests that the McNulty Memorandum is having little impact on halting requests for privilege waivers.[21]

d. Waiving privilege does not ensure amnesty or even more favorable conduct. Rather, it is a factor prosecutors consider. It may have significant adverse consequences, including the following:

i. It is widely believed that SEC and DOJ prosecutors take a dim view of companies that refuse to waive privilege. Declining to waive privilege denies law enforcement officials of materials such as internal notes from witnesses which they may not otherwise obtain, particularly if those witnesses later refuse to testify in the SEC or DOJ inquiry. While it is axiomatic that law enforcement is not entitled to obtain through the back door what it can not obtain through the front,[22] there is little doubt that refusing to waive privilege results in more than a simple loss of cooperation credit that might otherwise be obtained.[23]

ii. The privileged material will be subject to production in any class actions, derivative suits or other related proceedings. Frequently, an SEC civil and/or a DOJ criminal investigation is followed by class action securities fraud complaints against the company and its senior officers. Shareholder derivative suits may also be filed. All of the investigative materials which might otherwise be shielded from production will potentially be requested in discovery in these suits. Since the production to the SEC waives any applicable privileges, all of the materials will be subject to

[21] Letter from E. Norman Veasey, former Chief Justice, Delaware Supreme Court, to Senate Judiciary Committee (Sep. 13, 2007), available at http://www.nacdl.org/public.nsf/whitecollar/wcnews087/$file/ac_veasey.pdf.

[22] *Wong Sun v. United States*, 371 U.S. 471 (1963); *see also, Murray v. U.S.*, 482 U.S. 533 (1988); *Nardone v. U.S.*, 308 U.S. 338 (1939).

[23] The staff routinely claims, for example, that it is entitled to draw an adverse inference if a witness declines to testify based on the Fifth Amendment under *Baxter v. Palmigiano*, 425 U.S. 308 (1976). Since *Baxter*, involved an adversarial proceeding, the propriety of this position in an SEC investigation (which is a fact-finding inquiry) is questionable at best. *See, e.g.*, *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984).

discovery in these actions. The production of these materials may be harmful to the company and/or any employees in these suits.

iii. Waiver may make it more difficult for the company to fully investigate the matter and may, in fact, undermine the ability of the company to obtain cooperation credit.

(a) Employees may wish to cooperate with an inquiry by the company. At the same time, employees may be reluctant to cooperate with the SEC and DOJ for a variety of reasons. If the company waives privilege as part of its efforts to cooperate with the SEC, employees who do not want to cooperate with the government may refuse to cooperate with the company. This can impede the ability of the company to fully investigate the matter.[24]

(b) Even employees who might otherwise cooperate with the company and the SEC, may, in view of recent trends, be reluctant to be interviewed by company investigators in view of recent events.[25]

- In *U.S. v. Stringer,* Civ. Action No. 06-30100 (9th Cir. filed Apr. 4, 2008), the court held that the U.S. Attorney's office could use SEC investigators to collect evidence against targets of its investigation and set up those targets for potential false statement and obstruction charges without disclosing the criminal inquiry as long as the witnesses were furnished with SEC standard form 1662 prior to their SEC testimony. That

[24] The company may terminate employees who decline to cooperate with its inquiry. If, however, the company takes that action at the request of law enforcement officials, it may violate the constitutional rights of the employees. *See, e.g., U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2007) (concluding that the constitutional rights of KPMG employees were violated by firm acts taken at the direction of prosecutors seeking to compel their cooperation with a government investigation). If the company is in a regulated industry such as the brokerage business, the employee may have little choice except to cooperate. NASD Rule 2511 (Failing to provide information to investigators is lack of cooperation which can result in bar from industry); *but see In the Matter of the Application of Frank Quattrone,* Securities Exchange Act of 1934, Release No. 53547, Admin. Proc. File No. 3-11786 (Mar. 24, 2006) (SEC decision setting aside NASD complaint that Quattrone failed to cooperate with an agency investigation when he asserted his Fifth Amendment rights).

[25] As one commentator noted: "One major problem [with cooperation policies that call for waiver] is that these kinds of policies invite investigating counsel to bow to the pressure to become participants in a *sotto voce* effort to obtain incriminating information from corporate constituents without basic procedural protections." Sarah Helene Duggin, *Internal Corporate Investigations: Legal Ethics, Professionalism and the Employee Interview*, 203 COLUM. BUS. L. REV. 859, 952 (2003).

form states, among other things, that the SEC may make any evidence it collects available to the Department of Justice. The reason prosecutors chose to conceal the criminal inquiry was to make sure the witnesses continued to cooperate with the SEC – that is, testify. In essence, the ruling permitted the criminal prosecutors to obtain testimony and statements that they might not otherwise have obtained because the witnesses may have involved their Fifth Amendment rights. This undercut the rights of the defendants. Corporate employees faced with a request for an interview by a company investigator following a waiver of privilege by the company may elect not to assist the company in view of *Stringer.*[26]

- The current trend toward deputization may increase the reluctance of employees to cooperate with the company if privilege is waived. In these cases, the government has prosecuted individuals for making false statements to private lawyers conducting an internal corporate investigation when the witnesses knew that the information would be given to government prosecutors. This trend may also make the employee reluctant to cooperate with a company that has waived privilege – particularly if there is limited time to prepare for the interview.[27]

(c) If employees decline to cooperate with the company's inquiry, it undermines the ability of the organization to complete its inquiry. This can impede the efforts of the organization to fully

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26 *But see U.S. v. Scrushy,* 366 F. Supp. 2d 1134 (D. Ala. 2005) (SEC testimony suppressed for prosecutorial/misconduct similar to *Stringer*).

27 *U.S. v. Kumar*, Case No. 1:04-Cr-00846 (E.D.N.Y. 2006) (3 defendants pled guilty to false statement charges based on statements made to internal investigators who were private lawyers); *U.S. v. Valencia*, Case No. 4:04-cr-514-SS (S.D. Tex. filed Nov. 14, 2004) (prosecution of two corporate employees for false statements made to internal investigators; Rule 29 motion of one defendant denied). *See also*, N. Richard Janis, Taking the Stand: Deputizing Corporate Counsel as Agents of the Federal Government, Washington Lawyer (March 2005); George Ellard, Making the Silent Speak and the Informed Wary, 42 Am. Crim. L. Rev. 985 (2005).

remediate the problems, a critical element of cooperation under *Seaboard*. In addition, a key focus of the privilege waiver issue involves the production of witness interviews or notes of those interviews from the internal investigation. This is because in many instances, the testimony of the employees may not be otherwise available to the SEC, particularly in view of *Stringer*. No doubt this is the reason *Seaboard* specifically cites the production of interview notes with company employees and the person believed to be responsible for the fraud as a consideration in granting the company amnesty.[28] Indeed, if a number of employees refuse to cooperate, the SEC may believe that the company is not cooperating despite, statements to the contrary.[29]

G. ***Indemnification.*** Another critical issue which the business organization considering cooperation must evaluate is indemnification. While this is a standard corporate emolument, in the context of self-reporting and cooperation with the SEC and DOJ, the extension of the right can have a critical impact.

1. Most state corporation codes provide for the payment of reasonable legal fees and expenses for officers and directors for matters relating to their employment. Many corporations have included this right in their articles of incorporation. Indeed, as the court concluded in *Stein,* given the cost and expense of most complex corporate litigation, most would not be able to retain counsel experienced in such matters which is key to effective representation.

2. When the company elects to indemnify its employees, it may raise concerns regarding whether the organization is fully cooperating. This is

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28 *Seaboard* Release, Securities Exchange Act of 1934 Release No. 44969 (Oct. 23, 2001), available at www.sec.gov/litigation/investreport 134-44969.htm.

29 A key question in each investigation is how to deal with employees who may be involved with the malfeasance. For example, in *Seaboard*, those involved were terminated. If the evidence is clear, the decision may be straightforward. In many cases, the evidence may be less than clear or the company may have a different view from the prosecutors based on business considerations. This can cause significant difficulties. A failure to terminate employees believed by law enforcement officials to be culpable may, at a minimum, undermine any effort to obtain cooperation credit. As the Thompson Memorandum notes: "In evaluating a corporation's response to wrongdoing, prosecutors may evaluate the willingness of the corporation to discipline culpable employees of all ranks and the adequacy of the discipline imposed." Thompson Memorandum at 6. While this discussion was deleted in McNulty, under the McNulty Memorandum , how culpable employees are treated can still be considered. McNulty Memorandum at 15. *See also U.S. v. Stein,* 435 F. Supp. 2d 330 (S.D.N.Y. Jun. 26, 2006) (suppressing witness statements where employer KPMG pressured witnesses to testify to demonstrate cooperation and avoid prosecution).

particularly true if indemnification extends to those whom the SEC or DOJ believes are culpable.[30]

3. Those concerns may intensify if a number of employees elect not to be interviewed during the internal inquiry and/or cooperate with the SEC or DOJ inquiry. Under these circumstances, it may appear that the organization's claims of cooperation are less than sincere.[31]

H. ***Common interest agreements.*** The decision of the company regarding whether to enter into a common interest agreement with its current and former employees is an important issue which must be resolved in the context of the large question of self-reporting cooperation. This decision, like those regarding privilege waivers and indemnification, can have a significant impact on the investigative efforts of the company, as well as its efforts to cooperate with the SEC.

1. Common interest agreements permit a business organization to share information and materials with its employees and former employees regarding the case. The information shared is protected by privilege.

2. These agreements are frequently critical to employees. In view of the key role documents typically play in SEC investigations, absent access to the company files, the employee and his or her counsel may find it difficult if not impossible to properly prepare for interviews with investigators or the SEC or DOJ.

3. Without access to the pertinent files of the company, the employee may elect not to cooperate, impeding the corporation's inquiry as well as its efforts to cooperate with the SEC.

4. In contrast, entering into such agreements with employees, particularly those who may be viewed as culpable by the SEC or DOJ, may suggest to government investigators that the company's claims of cooperation are less than sincere. This difficulty may be compounded if a number of employees with whom the company has executed these agreements elect not to cooperate with the SEC or DOJ.

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[30] *See, e.g.,* SEC Release 2004-67, May 17, 2004, available at www.sec.gov/news/press/2004-67.htm (settled with Lucent Technologies in which the company paid a $25 million fine for expanding the category of credits to whom it would give indemnification during investigation); *Cf.*, Chairman William H. Donaldson, Speech of SEC Chairman: Remarks Before the New York Financial Writers Society, June 5, 2003, at http://sec.gov/news/speech/spch060503whd.htm (expressing concern regarding companies that indemnify officers and directors against disgorgement and fines in SEC and other actions); *see also* Bennett at 10 ("The company may be well advised to distinguish between employees who are not known to be culpable, and culpable employees …").

[31] *See, e.g.,* McNulty Memorandum at 11 noting that a prosecutor can ask whether the company is indemnifying its employees and take that point into consideration in the charging process.

I. ***Collective impact.*** The questions covering privilege waivers, indemnification and common interest agreements must be carefully evaluated in the overall context of the decision on self-reporting and cooperation. While each is a separate issue and, in other contexts, may be viewed as "standard procedure," in the pressurized environment of an SEC and DOJ charging decision, these questions take on a different character.

1. If the organization is viewed as less than candid in its pleas of cooperation, it can make an already difficult situation even worse. This can happen if, for example, the company is unable to fully assess the potential malfeasance because key witnesses, with whom it is sharing information in a privileged setting, are refusing to meet with internal investigators on the advice of counsel paid for by the company.

2. In contrast, failing to extend standard indemnification rights can impede or effectively deny employees effective counsel. Likewise, refusing to enter into common interest agreements can effectively undercut the ability of the employee to prepare to testify or defend him or herself. Placing employees in these circumstances can undermine the long-term ability of the organization to maintain a talented work force. Indeed, it is for this very reason that most states have adopted indemnification statutes as part of their corporate code.

IV. Conclusions

A. In certain instances, business organizations have a legal obligation to self-report discovered instances of malfeasance. In others, there is, at minimum, significant pressure and, in the view of some, an obligation to self-report, remediate and cooperate with enforcement officials.

B. The standards governing cooperation are vague and open-ended, leaving business organizations wishing to cooperate to guess as to what is required

C. While there appears to be benefits to cooperating, the precise nature of these benefits is difficult, at best, to discern.

D. There are clear costs to cooperating with law enforcement which may, in some instances, outweigh the benefits of cooperation. The costs may include waiving privilege, limiting indemnification rights and not entering into common interest agreements. The position of the company on these issues can have a significant impact on its ability to fully investigate a matter, take the appropriate remedial action and ultimately cooperate with the SEC. Likewise, the resolution of these issues can have significant long-term business effects on the organization's relationship with its employees.

E. In sum, the question of self-reporting and cooperation in most instances must be carefully evaluated in each situation.