BACK AGAINST THE WALL

Corporate Deferred Prosecution Through the Lens of Contract "Policing"

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Deferred prosecutions are not new. In a deferred prosecution agreement, a defendant receives the benefit of not being prosecuted, or the prosecution is held in abeyance, in return for his or her compliance with set conditions. Often, the key condition is that the individual not engage in future criminal conduct. Upon a set period of time expiring, the deferred or nonprosecution agreement is considered completed and the individual is free to resume his or her life without restriction.

In recent years, there has been a growth in the number of corporate deferred prosecution agreements. This phenomenon may, in part, be an outgrowth of the establishment of the President's Corporate Fraud Task Force, the revision of the *Principles of Federal Prosecution of Business Organizations Memo* under Former Deputy Attorney General Larry Thompson, or an increased emphasis on curtailing corporate fraud in a post-Enron world. It may be the result of a desire to avoid collateral consequences of prosecution, such as seen in the *Arthur Andersen, LLP* case, or a corporate need to contain possible civil litigation resulting from prosecution. Or it may be nothing more than an increased flexing of prosecutorial power. Clearly, the need to avoid debarment or exclusion from government contracts or benefits often provides no choice to a company but to enter into a deferred prosecution agreement.

In a post-*Arthur Andersen* world, corporations readily accept a deferred prosecution agreement, no matter what the terms, as an alternative to a corporate death sentence. The Arthur Andersen, LLP, indictment and subsequent prosecution devastated the company. The later U.S. Supreme Court decision that reversed the company's conviction was superfluous in light of the collateral consequences already suffered as a result of the government indictment. Thus, the innocence or guilt of the corporation becomes irrelevant in a world of potential civil shareholder lawsuits and devastating power wielded by the government. Companies are ready to sign agreements to cooperate fully with the government, even to the extent of not providing executives with previously contracted attorney fees, in order to obtain a deferred prosecution agreement that will allow the company to continue operating as a business.

Some complaints have been levied against the government for not making this process more transparent. This is especially vital when some companies bypass criminal prosecution with a deferred prosecution agreement, while others are subjected to criminal prosecution. In addition to voices for consistency in providing the benefit of a deferred prosecution, objections are being raised to the agreements themselves or to the process used by the government in obtaining them. Although the government has recognized one problem and issued a guideline to restrict "terms requiring the defendant to pay funds to a charitable, educational, community, or other organization or individual that is not a victim of the criminal activity or is not providing services to redress the harm caused by the defendant's criminal conduct," it has not addressed other problematic aspects of these agreements. (U.S. Atty. Man. 9-16.325.) Three examples of egregious provisions in deferred prosecution agreements are ones that waive the attorney-client privilege, grant the government the sole right to determine whether the agreement has been breached, and allow the government to interfere with a previously negotiated contract provision.

The Agreement: Attorney-Client Privilege

Perhaps the most controversial provision sometimes seen in deferred prosecution agreements is a request that the corporation waive its attorney-client privilege. The source of this provision is likely found in the *Principles of Federal Prosecution of Business Organizations Memorandum,* commonly referred to as the Thompson Memo. This memo for internal guidance of Department of Justice attorneys lists factors to be considered in deciding whether to charge a corporation with criminal conduct. One of the factors from

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the Thompson Memo that works in favor of the corporation not being indicted is its "timely 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." Thus, a corporation facing possible prosecution may avoid the indictment when it cooperates with the government by providing attorney-client material. From the government's perspective, having the corporation provide this evidence will mean stronger cases against individuals. The government also avoids a lengthy investigation process when the corporation packages the items for the government to use in a later prosecution of corporate employees.

Vocal criticism by several groups were the likely impetus for the Department of Justice's initial revision of internal policy in first the McCallum Memo. (Robert D. McCallum, Jr., acting deputy attorney general, *Waiver of Corporate Attorney-Client & Work Product Protection* (Oct. 21, 2005)) and later issuance of the McNulty Memorandum (Paul J. McNulty, deputy attorney general, *Principles of Federal Prosecution of Business Organizations* (Dec. 12, 2006).) The McNulty Memo continues to allow waivers of the attorney-client privilege but provides restrictions on requests of this information, including the necessity to obtain approvals from the deputy attorney general for certain kinds of waiver of attorney-client or work product protections. Most recently, Acting Deputy Attorney General Craig S. Morford issued a memorandum regarding the selection and use of monitors in deferred and nonprosecution agreements, but this memo fails to address the attorney-client privilege issue.

The United States Sentencing Commission initially had a provision that encouraged these waivers by providing a benefit to corporations in the limited circumstance that the waiver was "necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization." The commission, however, adopted an amendment, effective November 1, 2006, that deletes from the corporate sentencing guidelines this particular sentence so as not to suggest it encourages corporations waiving the attorney-client privilege.

Finally, Senator Arlen Specter proposed legislation that would restrict "[i]n any Federal investigation or criminal or civil enforcement matter, an agent or attorney of the United States" from "demand[ing], request[ing] or conditioning treatment on" this information. The bill's purpose is "to place on each agency clear and practical limits designed to preserve the attorney-client privilege and work product protections available to an organization and preserve the constitutional rights and other legal protections available to employees of such an organization."

The attorney-client privilege, the work product protection, and client confidentiality are principles with strong constitutional, evidentiary, and/or ethical roots. At the heart of the attorney-client privilege is the goal of encouraging "full and frank communication between attorneys and their clients and thereby promot[ing] broader public interests in the observance of law and the administration of justice." (Upjohn Co. v. United States, 449 U.S. 383, 389 (1981).) The work product protection specifically covers pretrial matters. Confidentiality, a core principle that promotes the ethical duty of loyalty to the client, is a part of a variety of ethical rules governing practicing attorneys. The ethical rules often provide mandates beyond those encompassed within the attorney-client privilege and work product doctrine.

The attorney-client privilege is an important component of the United States justice system. The Supreme Court has held that it applies even after the demise of the client. Some go so far as to maintain that confidentiality between the attorney and client rises to the level of Sixth Amendment coverage in that the Sixth Amendment right to counsel incorporates "meaningful" representation, something that cannot be assured absent protected communication between the attorney and client. (Swidler & Berlin v. United States, 524 U.S. 399 (1998).) There are, however, exceptions to the attorney-client privilege. For example, one cannot use the attorney-client privilege to perpetrate a crime or fraud.

Corporate waiver of the attorney-client privilege has significant ramifications. Compliance programs are likely to prove ineffective when employees are unwilling to participate and provide information for fear that the material may find its way to government prosecutors. Knowing that the corporation may waive the attorney-client privilege, corporate employees may be less likely to report internal corporate problems, to seek advice in resolving possible legal issues, or to cooperate with internal and external auditors who may be investigating corporate misconduct. Transparency diminishes when employees fear that the government may discover their statements and documents.

The Agreement: Judicial Oversight

The prosecution dominates in deferred prosecution agreements as these agreements often include provisions that the government will be the sole determining body of any breach by the corporation. Some agreements specify that this determination is not subject to review—unlike the classic plea bargain scenario in which a court must determine whether the defendant understands that rights are being waived and that the defendant's assent is voluntary, intelligent, and knowing.

Often the agreement will provide that the company has a time period to contest the determination of breach with the Department of Justice. The agreement may even provide that upon the government deciding a breach has occurred, the admissions made by a company in reaching the agree-

ment will be deemed admissible. One agreement goes so far as to allow the government to select from several different options the remedy it desires for the purported breach of the agreement by the company.

The Agreement: Attorney Fees

Recently, a practice that has caused significant controversy is one that calls for the company not to pay for or reimburse attorney fees of employees indicted by the government. The issue of payment of attorney fees is prominent in the recent KPMG related case of *United States v. Stein I*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006), as the company withheld attorney fees despite a long-standing practice of paying "the legal defense of its personnel, regardless of the cost and regardless of whether its personnel were charged with crimes." During the company's negotiation to obtain a deferred prosecution agreement, the assistant U.S. attorneys had meeting points that included questions of whether KPMG was paying or planned to pay the legal fees of its employees. Judge Kaplan of the Southern District of New York found that government interference with employees' rights "to a fair trial and to the effective assistance of counsel" violated the Fifth and Sixth Amendments to the Constitution. As eloquently stated by Judge Lewis Kaplan in an opinion, "KPMG refused to pay [the attorney fees of individuals indicted] because the government had the proverbial gun to its head." This district court judge also noted that "[h]ad that pressure not been brought to bear, KPMG would have paid these defendants' legal expenses." In *United States v. Stein II*, 495 F. Supp. 2d 390 (S.D.N.Y. 2007), Judge Kaplan reexamined the remedy issue and found that the prosecutor's conduct was "outrageous and shocking." He then dismissed 13 defendants from this criminal case. The *Stein* case remains under review.

Contracts

Absent from this deferred prosecution approach is a focused contract theory. Although contract law has served a critical role in the interpretation and enforcement of plea bargains, deferred prosecution agreements have not been held to the test of that law. Specifically, there is no recognition of established policing mechanisms developed by the courts to oversee the agreements reached by the parties to a contract. Thus, the government acquires total power over the alleged corporate offender. The net result is that deferred prosecution agreements are reached without considering theories of duress, unconscionability, or other policing doctrines.

The use of contract law to enforce promises in the criminal justice system began more than 35 years ago with the Supreme Court's decision in *Santobello v. New York*, 404 U.S. 257 (1971). In *Santobello*, the state failed to adhere to a bargained promise it had made to the accused as part of a plea negotiation. The Court used a typical contract analysis and noted that, although circumstances may vary, when a prosecutor makes a promise and it is at least part of the consideration for a defendant's guilty plea, the promise must be fulfilled.

Since *Santobello*, courts consistently use contract law to analyze plea agreements gone awry in the criminal justice system. For example, courts apply contract principles in matters such as interpretation of plea agreements, use of canons of construction, the law of conditions, promissory estoppel, the parol evidence rule when ascertaining the ability of a party to add an oral promise to a plea bargain, material breach versus substantial performance analysis, modification of contracts, frustration of purpose, intent-driven interpretation, the need for consideration to make an agreement binding, illusory promises, and assumption of the risk of future changes in the criminal law that work to the disadvantage of the defendant.

Duress and unconscionability are policing concepts used by the courts to restrain a contracting party with superior bargaining power from taking advantage of a less powerful party. These concepts place limits on the enforceability of agreements that are unfair and one-sided. Courts do not necessarily invalidate entire contracts when providing this equalizing function. Rather, a court may remove troubling terms within a contract yet keep intact the remainder of the agreement.

The doctrine of duress considers whether a party to a contract is entering the contract because of compulsion instead of true assent to the contract terms. Parties that enter contracts under compulsion may be relieved of their duties under that contract if it is shown that the elements of duress were present at the time of contracting. The problem with duress is one of degree. When duress is claimed, a court must determine whether the compulsion was so serious and wrongful that it should refuse to enforce the contract or, alternatively, undo the contract.

When applying duress, a court needs to consider the disparity of bargaining power between the parties and whether the resulting agreement is unfair. Is the party with the stronger bargaining power requiring agreement to a term that is unacceptable and only being agreed to because of the potential consequences of not reaching an agreement? For example, if the stronger party requires that the weaker party waive the attorney-client privilege, even though the ethical rules normally support the privilege, has the more powerful party made a wrongful threat? Although it is not easy to determine what exactly the proper limits are in bargaining, this article suggests that the government has clearly gone beyond the acceptable limits in certain situations.

Another concept that may be useful in determining whether deferred prosecution agreements or specific terms in these agreements can withstand scrutiny is the doctrine of unconscionability. An inquiry into whether a contract or

any term of a contract is unconscionable requires the court to consider first whether the contract is a result of free bargaining. If a contract is not the result of true bargaining and the stronger party essentially dictates the terms, the resulting contract is one of adhesion. The mere fact that a contract is one of adhesion will not mean that a contract is unconscionable per se. Contracts of adhesion, however, require a court to scrutinize the contract more carefully for fairness issues than one that is the result of bargaining.

One of the most troubling features of unconscionability is that there is no clear definition of the concept. The closest a court has come to a definition is in the celebrated case of *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965), where the Court of Appeals for the District of Columbia declared, "[u]nconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party."

This has led courts to use a two-part analysis to determine whether a contract is unconscionable. Although a few courts have held that a single term may be so unconscionable as to infect an entire contract, most courts agree that a court must find both procedural unconscionability and substantive unconscionability before it strikes down a term or an entire contract.

Although there is no definition of unconscionability, comments to the *Restatement (Second) of Contracts* lists factors that may be helpful to a court in determining whether procedural unconscionability exists. These factors include:

- where the party in a superior bargaining position does not believe there is a reasonable probability that the other party will perform the contract;
- where the more powerful party knows that the other party will not be able to receive a substantial benefit from the contract; or
- knowledge by the stronger party that the other party is unable to reasonably protect his or her interests.

Other factors that may be important are the timing of the contract and the alternatives available to the complaining party.

Before applying the contract policing principles described above to deferred prosecution agreements, it is important to note one key difference in the application of contract doctrine to agreements made in the criminal justice system. Most notably, courts do not apply contract law strictly when analyzing these agreements. They infuse constitutional considerations and fairness doctrines as important components to the analysis of these agreements.

Contracting parties in the criminal justice system are held to a different standard than those in the commercial law field. Instead of private individuals exchanging promises for the benefit of each other, one of the parties is now the government, a party with enormous power. This changes the stakes dramatically. Courts recognize that when one of the contracting parties is the government, the typical contract rules that are used in the commercial area should not be applied identically. The rules shift to favor the accused who enters into an agreement with the government.

Defendants have constitutionally mandated rights that may not be ignored in the judicial process. Because the Constitution places limitations on the prosecution in a criminal case and gives a defendant certain fundamental rights, the law of contract, which may seem harsh at times when applied to private contracting individuals, is tempered. These underlying constitutional limitations do not have a direct corollary in the commercial world. Private individuals have more latitude to enter into contracts, irrespective of whether those contracts represent poor negotiations. In contrast, the accused in a criminal case is given certain protections under contract law. Thus, when courts rule on the formation and enforceability of these criminal-related contracts, they are obliged to consider the agreements more critically than they would if they were simply determining the rights of private individuals who enter into a contract for their own benefit.

Courts also use their supervisory power to address the fairness of agreements between the government and the accused. The Court in *Santobello* stated, "all of these considerations presuppose fairness in securing agreement between an accused and a prosecutor." The cases are replete with concern beyond protecting strict constitutional rights "to concerns for the honor of the government, public confidence in the fair administration of justice, and the effective administration of justice in a federal scheme of government." (United States v. Ready, 82 F.3d 551 (2d Cir. 1996).) The courts' demands for utmost fairness by the prosecution are most relevant to the issues of policing agreements in the criminal justice system. Because of a supervisory concern for fairness, the courts have held the government to a greater degree of responsibility than if it were an individual entering into private contracts. Thus, prosecutors have been foiled when they have tried to take advantage of the parol evidence rule to keep promises out of written agreements, to use imprecise language to the government's advantage, to use narrow interpretation principles to change the government's obligations as to further prosecutions of the defendant, and to use other rules of interpretation to get to what appears to be an inequitable result.

One reason for scrutinizing the government's behavior and its agreements is that courts are cognizant of the fact that government attorneys wield far superior bargaining power than the individual or corporation who is accused of criminal conduct. As one court noted, "[s]ometimes general fairness principles will require us to invalidate particular

agreement terms." (United States v. Aleman, 286 F.3d 86 (2d Cir. 2002).) This vastly differs from how courts resolve issues concerning private contractual agreements.

Deferred Prosecution Agreements and Contracts

When examining deferred prosecution agreements through the lens of contract law one finds differences unique to the criminal justice system. Although there may be many questionable provisions in various deferred prosecution agreements, the terms selected here are particularly egregious. The doctrines of duress and unconscionability raise serious concerns as to the viability of these provisions. This is particularly true in light of the fact that courts examine contracts in the criminal justice system much more closely than they do an agreement between two private individuals.

Corporations have a strong incentive to enter into agreements that waive the attorney-client privilege and waive the right to have a judicial determination of whether there is a breach of contract. The government power also forces them to breach a duty to pay previously negotiated attorney fees of corporate employees being accused by the government of possible crime. Despite the reversal of the *Arthur Andersen, LLP* conviction, the destruction of the company provides a compelling motivation to other corporations to agree to whatever terms are requested by the government. Being successful in the judicial system may not save the corporation from ruin caused by merely being indicted. Even those companies that do not lose clients due to their professional role and are not subject to exclusion or debarment face potentially crippling civil actions.

These agreements are made under duress. There is the threat of government indictment and resulting destruction of the entire business that induces the manifestation of assent to the deferred prosecution agreement. But for the threat of possible prosecution by the government and its resulting consequences, these terms would not normally be agreed to by the corporation. In fact, normally there would be no incentive for a corporation to willingly agree to these terms. Without doubt, the threat is serious and sufficiently grave in that the possible manifestations of a failure to agree and the destruction or loss of business are overwhelming. Should a company not sign the agreement with the government, it opens itself up to potential derivative actions by shareholders. Outsiders may also find a basis for a civil action, or use this evidence in pending civil matters, to claim that the company was not acting responsibly. The shaming caused by the publicity of this matter is a strong motivation for a company to agree to any terms presented by the government. This can be especially true when the company's product is sold on the open market. Other businesses may also feel compelled to avoid association with the company out of fear of the stigma caused by the government allegations.

Even though conduct by the government may be legal and with the beneficial motivation of stopping criminal conduct within the public, it is improper and wrongful to force the corporation to agree to terms that it would not accept under normal bargaining circumstances. Contract provisions that require the corporation to agree to abide by the law, place internal monitors as oversight, and pay a fine for prior wrongdoing are legitimate provisions that are directly connected to the alleged wrongdoing and will protect the public. In contrast, waiving attorney-client privilege raises ethical issues, has constitutional implications, and is diametrically opposed to a basic tenet in the evidentiary structure of our legal system. The removal of the judiciary from the decision whether there has been a breach of contract also extends beyond the bounds of normal contract terms because it removes the objective decision maker from the process. Asking a corporation to sign an agreement that essentially interferes with the private contract rights between itself and its employees puts the corporation in the position of potentially being sued by the corporate employee for breach of contract. Forcing a party to breach a contract is improper and wrongful.

In addition to the elements of classic duress, these provisions should be removed because they are agreed to under economic duress. The economic reality is that if the corporation refuses to assent to the deferred prosecution agreement, there is the potential of death of the corporation or alternatively, severe financial repercussions that will gravely injure the corporation. These consequences may result from an indictment even if the corporation is later declared innocent.

Although there are both procedural and substantive aspects to unconscionability, there are occasions when either the procedural or substantive terms or processes are so egregious that they cause the contract or the terms within the contract to fail. Both types of unconscionability exist in deferred prosecution agreements, but even without a finding of procedural and substantive unconscionability, courts may find that the government entering into certain deferred prosecution agreements is inherently unfair. Courts may use supervisory powers to quash these agreements.

The procedural deficiencies are apparent when one looks at the gross disparity in bargaining power of the parties. The power of the government is massive in comparison to the corporation's need to avoid publicity, stigma of an investigation, shareholder lawsuits, or a possible death sentence for the corporate entity. This unequal bargaining position of the parties is a far cry from what is seen in the normal circumstances between private parties who enter into contracts at arm's length.

The specific terms within the contract also evidence substantive unconscionability. A term, such as waiving the attorney-client privilege, is offensive because it goes against

fundamental tenets of the adversary system of justice in the United States. Asking for this waiver is diametrically opposed to ethical considerations within the legal profession. So too, allowing one party to have the sole determination as to whether there was a breach of contract also is substantively unconscionable as it removes the legal system from the enforcement phase of the contract process. One can hardly call it a fair bargain when one party is left to the whim of the opposing party to determine the basis, the existence, and the punishment for a breach. Likewise, allowing the government to provide a benefit to a corporation for breaching a preexisting contract is especially unfair to the contract rights of the third parties that suffer from this government interference. This can result in litigation against the corporation for the breach of contract.

Prosecutors have enormous discretion in the charging process. They also have discretion in deciding whether or not to proceed once a case has been filed. Deferred and nonprosecution agreements serve an important role in securing corporate compliance, avoiding costly trials, and protecting innocent parties from corporate malfeasance. Despite the benefits here, it is important that the terms in these agreements pass contractual muster. Oversight is important, and the judiciary is clearly the appropriate one to serve that role. ■