Shedding Light on Its New Cooperation Initiative, the SEC Announces Its First Non-Prosecution Agreement with a Public Company

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When it filed securities fraud charges two weeks ago against a former executive of Carter's, Inc. ("Carter's"), the children's clothing company, the SEC also announced its first ever non-prosecution agreement between it and a public company. The agreement was entered pursuant to the initiative the SEC unveiled last year to encourage and reward cooperation with SEC investigations and enforcement actions. The agreement provides the first glimpse into how the SEC will implement an initiative that received widespread attention when it was launched but whose details had been somewhat unknown.

The Carter's non-prosecution agreement enabled the company to avoid potential securities fraud charges in an apparent reward for significant cooperation—Carter's had self-reported the former executive's wrongdoing to the SEC, conducted an in-depth and thorough internal company investigation, cooperated with the SEC's inquiry, restated some of its earnings, and adopted extensive remedial measures. These features are especially noteworthy because one SEC official described Carter's experience as a "road map" for earning a non-prosecution agreement. At the same time, in a development that will be welcomed by many securities practitioners, the agreement does not include any statement of uncontested facts by Carter's or otherwise require Carter's to admit any wrongdoing.

At the very least, the Carter's agreement is another reminder of how companies can position themselves for leniency in the event of employee wrongdoing by operating robust compliance programs, conducting thorough internal investigations in response to signs of potential wrongdoing, promptly self-reporting to government regulators any misconduct that is identified, and cooperating with the authorities as they conduct their own investigations.

THE SEC'S EFFORTS TO ENCOURAGE AND REWARD COOPERATION

Last January, the SEC unveiled a program to extend leniency to companies and individuals who report securities laws violations and cooperate with regulatory investigations and enforcement actions. To encourage cooperation, the program authorized the SEC's enforcement staff to use various tools that federal criminal prosecutors long had used, but that had not been available in connection with SEC inquiries. One of these tools is the non-prosecution agreement—an agreement in which the SEC declines to charge cooperators who, among other things, agree to fully cooperate with the SEC's efforts and comply with other obligations set out in the agreement. But the SEC's initial announcement lacked many details concerning how and when it would use these tools or what kinds of concessions and undertakings it would require from cooperating companies. In publicly disclosing the Carter's non-prosecution agreement two weeks ago, the SEC has begun to answer these open questions.

THE CARTER'S NON-PROSECUTION AGREEMENT

In a complaint filed on December 20, 2010, the SEC charged Joseph M. Elles, Carter's former executive vice president for sales, with fraud and insider trading. The complaint alleged that Elles fraudulently concealed large, unauthorized discounts to Carter's largest wholesale customer by persuading the wholesaler to delay deducting these discounts from its payments to Carter's until later reporting periods. The complaint further alleged that Elles then signed documents that misstated these discounts. According to the SEC, this conduct enabled Carter's to overstate its quarterly net income by as much as 19 percent. As a basis for the insider trading charges, the SEC alleged that Elles realized nearly $5 million by trading in Carter's stock while aware of this undisclosed accounting fraud.

Carter's avoided potential charges based on Elles's conduct by signing the non-prosecution agreement with the SEC. Under the agreement, Carter's committed itself to cooperating fully and truthfully in any further SEC investigation concerning the alleged accounting fraud and the enforcement action now pending against Elles. As part of its ongoing cooperation obligations, Carter's is required to turn over all non-privileged documents, information, and other materials requested by the SEC, and to use its best efforts to make its current and former directors, officers, employees, and agents available for interviews and testimony. Importantly, it appears that the company was not required to waive any applicable privileges in order to obtain this treatment.

The agreement states that it "should not . . . be deemed exoneration of [Carter's] or be construed as a finding by the Commission that no violations of the federal securities laws have occurred." Nonetheless, it does not contain a statement of undisputed facts or otherwise require Carter's to admit or deny any facts concerning the alleged misconduct. This permits Carter's to deny liability for the alleged accounting fraud in legal proceedings not involving the SEC, a significant benefit to any company facing the likelihood of related shareholder lawsuits. In the words of the agreement: Carter's agrees not to take any action or make any public statement, "except in legal proceedings in which the Commission is not a party, denying, directly or indirectly, the factual basis of any aspect" of the agreement.

Of course, Carter's faces significant consequences if it violates the agreement by, for example, failing to cooperate fully and truthfully in any ongoing investigation by the SEC related to the alleged accounting fraud and in the SEC's enforcement action against the former executive. In the event of a breach, the agreement not only authorizes the SEC to file an enforcement action against Carter's for any related or unrelated violations, but it permits the SEC to use in future legal proceedings any information that Carter's provided in the course of cooperating as well as any evidence derived from that information. It also permits the SEC to bring any claim against Carter's that was not time-barred as of the date on which the agreement was signed. (To the extent these will be standard terms in non-prosecution agreements, some companies might be better off, depending on the circumstances, pursuing the traditional disposition that the SEC has long offered to settling companies—payment of a fine and an injunction barring the wrongdoing at issue but with no ongoing cooperation obligations.)

LOOKING AHEAD: INSIGHT FROM THE CARTER'S NON-PROSECUTION AGREEMENT

The SEC's longstanding practice has been to allow parties facing an enforcement action to settle without admitting or denying any wrongdoing. When the SEC announced it would begin using cooperation, non-prosecution, and deferred prosecution agreements, some securities practitioners feared the SEC would require cooperators to admit wrongdoing as part of these agreements, much like the practice in federal criminal matters. At that time, the SEC stated in its Enforcement Manual that as part of deferred prosecution agreements, cooperating entities "under certain circumstances . . . [would be expected to] agree either to admit or not to contest underlying facts that the Commission could assert to establish a violation of the federal securities laws." If required to make admissions in a public agreement, however, those admissions might be used by criminal authorities to mount criminal charges or by civil lawyers as a basis for private securities fraud actions, limiting the usefulness of these agreements to companies. The absence of any admissions or statement of uncontested facts in the Carter's non-prosecution agreement is a promising development for companies seeking to avoid potential SEC charges through cooperation but concerned that doing so might increase their exposure to criminal or private securities fraud claims.

What the Carter's non-prosecution undoubtedly demonstrates is the substantial benefit that companies can derive from self-policing for employee misconduct, conducting internal investigations, self-reporting any misconduct that is discovered, cooperating with the authorities, and adopting appropriate remedial measures. In announcing the SEC's decision not to file charges against Carter's, the SEC's director of enforcement emphasized that "Carter's did the right thing by promptly self-reporting the misconduct, taking thorough remedial action, and extensively cooperating with our investigation, for which it received the benefits of a non-prosecution agreement."

Together with the recently-enacted whistleblower provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act that are expected to trigger an increase in the reporting of corporate fraud by third parties, the leniency extended to Carter's is added incentive for companies to implement and operate robust compliance programs and to consider promptly self-reporting any misconduct that is substantiated. Under Dodd-Frank's whistleblower program, the SEC will pay potentially large financial bounties to virtually anyone who reports information that leads to a successful SEC enforcement action. By self-policing and self-reporting, management can reduce the risk that financially-motivated whistleblowers will approach the SEC first and undermine a company's ability to obtain leniency as a reward for having been the first to report the matter.

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017-3954
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3119 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000