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Takeaways From DOJ Civil Division's Inability-To-Pay Memo

By **Matthew Miner and Amanda Robinson** (September 10, 2020, 12:38 PM EDT)

Matthew Miner

Amanda Robinson

On Sept. 4, Acting Assistant Attorney General Ethan P. Davis issued a memorandum, "Assessing an Entity's Assertion of an Inability to Pay," to the U.S. Department of Justice's Civil Division. This guidance represents a capstone to Davis' tenure, coming three days after the announcement that he will be leaving the DOJ and three days prior to his effective departure on Sept. 7.

Although the Civil Division has long had a practice of taking into account an organization's inability to pay when negotiating civil settlements, the new guidance formalizes this practice and sets forth an analytical framework for evaluating and addressing a company's claim that it cannot pay a civil fine or monetary penalty. This guidance continues the DOJ's efforts in recent years to promote transparency both internally and outside the DOJ regarding its treatment of corporate investigations and resolutions.

The new guidance is helpful insofar as it clarifies the Civil Division's inability-to-pay process and criteria, but as further discussed below, many open questions remain.

For example, the guidance applies to inability-to-pay claims asserted in civil resolutions conducted by the Civil Division, but the guidance does not speak to how or whether the process and/or criteria apply to criminal investigations conducted by the division's Consumer Protection Branch or civil litigation principally managed by a U.S. attorney's office.

It is also important to consider that the evaluation process is a rigorous one that should not be taken lightly by organizations and their counsel. And, if not careful, the open-books aspect of the inability-to-pay process could leave an organization exposed and potentially disadvantaged during settlement negotiations and subsequent litigation.

Establishing Inability to Pay

Much like the Criminal Division guidance issued last year,[1] the Civil Division guidance makes clear that an organization asserting an inability to pay a fine or civil monetary penalty bears the burden of establishing its inability to pay. To do this, the Civil Division requires an organization to complete a financial disclosure form and certify under penalty of perjury the accuracy of its contents.

The required financial disclosure form is no small undertaking. It requires an organization to identify, among other things, assets and liabilities, current and anticipated income and expenses, cash flow, projections, and working capital. The organization must further provide any necessary supporting and supplemental documentation to include tax returns, audited financial statements, and access to the organization's relevant personnel.

Analyzing the organization's ability to pay can be a detailed and time-intensive process, with the Civil Division typically enlisting the assistance of a qualified financial expert. The organization is required to notify the Civil Division of any material changes to its financial condition and may request periodic updates until a final agreement is reached.

Additional Considerations

In addition to analyzing the organization's financial disclosure form and related documentation, the Civil Division is to consider a range of factors, including the following:

- Background on what gave rise to the organization's current financial condition and projected earnings and expenses, including whether the organization:
    - Engaged in related party transactions;
    - Removed capital through dividends, distributions, or loans, or invested in facilities expansion, capital improvements, or acquisitions; and/or
    - May reduce or eliminate discretionary expenses, such as executive bonuses.
- Alternative sources of capital including by borrowing funds via a mortgage on real property or raising capital through existing or new credit facilities or from the sale of assets or equity. The division will further evaluate:
    - Booked reserves, plans for the acquisition or divestment of assets, and the organization's forecasts; and
    - Insurance or indemnification agreements, or any other type of enforceable monetary claim against a third party.
- The amount an organization can pay immediately and over time, typically for a period of no more than three to five years, including interest and protection in the event of default or bankruptcy, and appropriate security including from a third party;
- Tax deductibility of the payment;
- Acceleration or escalation of contingency arrangements, such as forecasts of a future sale of significant assets, new product launch or contract, other new earnings, or growth opportunity;

- Significant adverse collateral consequences of a monetary resolution that exceeds the organization's financial capacity;

- Whether third parties may be liable for the debt as a result of fraudulent transfer, successor liability, or the federal priority statute.

Collateral Consequences

Aside from establishing a defined policy to evaluate corporate defendants' inability-to-pay claims, the most significant aspect of the guidance is its acknowledgement of collateral consequences as potential factors in the inability-to-pay calculus. In doing so, the Civil Division, in large part, tracks the Criminal Division's October 2019 guidance on this point. The Civil Division will take into account potential disproportionate impacts on an organization's ability to fund its obligations and operations as well as its ability to maintain certain assets required by law or regulation.

The memorandum also makes clear that certain collateral consequences are typically not relevant in assessing an organization's inability-to-pay claims. The following generally are considered not relevant: adverse impacts on growth, future opportunities, planned or future product lines, future dividends, unvested or future executive compensation or bonuses, and planned or future hiring or retention.

Notably, unlike the Criminal Division guidance, the Civil Division does not specifically identify the following factors as relevant collateral consequence considerations: layoffs, product shortages, or significant disruption to competition in the market.

Takeaways

Companies intending to pursue inability-to-pay claims must be prepared to complete the required financial disclosure form and provide the necessary supporting materials with openness and complete transparency.

Through the process outlined in the memorandum, the Civil Division will invest resources to ensure that it obtains the necessary level of expertise when reviewing and scrutinizing a company's financial condition and relevant assertions. Companies are well advised to expect Civil Division attorneys to closely monitor companies' public statements, especially those made to investors and through auditors.

In many ways, the significant burden the inability-to-pay process places on organizations serves as a barrier to those organizations whose claims are on the margin. Where there is uncertainty about an organization's current or continuing viability after payment of a fine or monetary penalty, the organization should consult and address such concerns with its outside auditor prior to asserting an inability-to-pay claim.

Although the Civil Division guidance omits reference to the Financial Accounting Standards Board standard for going-concern considerations, which was referenced in the parallel Criminal Division guidance, organizations would be well advised to consider that standard and its auditors' treatment of disclosure issues thereunder.

Another key consideration for organizations is whether they have an agreement in principle such that an organization's maximum exposure in the absence of an inability-to-pay claim is properly understood and effectively capped. The organization can be at a significant disadvantage if it opens up its books to the government ahead of a negotiated resolution. Notably, the Civil Division guidance is silent on this issue, whereas the Criminal Division guidance makes clear that, as a threshold matter, parties must first reach agreement on the fine amount prior to the Criminal Division considering inability-to-pay claims.

Similarly, there is no guarantee that the division will accept an organization's view of its inability to pay or that any reduced settlement demand will be acceptable to the organization. As such, organizations considering an inability-to-pay argument may be providing information about their financial condition that both could be used in litigation by the government and could be the subject of discovery in other litigation.

Further, it is important to note that not all cases handled by the Civil Division are necessarily covered by this guidance. For example, organizations negotiating criminal resolutions with the Civil Division's Consumer Protection Branch presumably would not have inability-to-pay claims falling under this new guidance. Additionally, it is unclear whether and to what extent this guidance applies to matters brought by U.S. attorneys' offices without the involvement of the Civil Division, such as certain matters brought under the affirmative civil enforcement program.

Finally, it is also not clear how this guidance and the process it outlines apply to nonintervened False Claims Act cases brought by relators; organizations should be mindful that relators' counsel will seek to access and evaluate an organization's financial information provided in support of an inability-to-pay claim.

Accordingly, it is critical that organizations understand what framework applies to them prior to asserting inability-to-pay claims and turning over their financial information.

Matthew Miner is a partner at Morgan Lewis & Bockius LLP and former deputy assistant attorney general at the U.S. Department of Justice.

Amanda Robinson is an associate at Morgan Lewis.

[1] https://www.justice.gov/opa/speech/file/1207576/download.