GT GreenbergTraurig

Alert | White Collar Defense & Special Investigations

July 2019

The Serco Deferred Prosecution Agreement: A Lesson in Pragmatism

On 4 July 2019 at Southwark Crown Court, Mr Justice William Davis formally approved the fifth Deferred Prosecution Agreement (DPA) entered into by the UK's Serious Fraud Office (SFO). The SFO's latest DPA is with Serco Geografix Limited (SGL), a now-dormant subsidiary of Serco Limited (SL), and marks the end of a six-year investigation which started in November 2013 when the Ministry of Justice (MoJ) reported concerns about its contract with SL for the supply of electronic monitoring equipment, i.e., ankle tags, used to monitor individuals accused or convicted of criminal offences.

According to the judgment, while the investigation 'revealed no evidence of any dishonest or fraudulent activity' in respect of the original concerns, Serco Group PLC, the ultimate parent, in reviewing material thought to be relevant to those concerns, discovered emails which appeared to show there had been manipulation of accounting between SGL and SL designed to artificially reduce the profit margins reported to the MoJ, giving rise to a potential fraud on the public purse. It was this discovered conduct which ultimately led to the DPA.

The judgment raises some interesting points of law and practice. In this GT Alert, we consider the facts and analyse the features of this latest UK DPA, the first under new SFO Director Lisa Osofsky.

The Background

SL held two contracts with the MoJ for the provision, installation, and removal of electronic monitoring devices as well as the actual monitoring of the devices. Both contracts were serviced by SGL, which manufactured and supplied the electronic tags.

The revenue generated by SL was dependent on the number of devices installed and the number of enforcement actions that resulted. As part of their Best and Final Offer during the bidding process, SL forecast a profit margin of 14% for the life of the contracts. The contracts also provided for the possible abatement of charges in the event SL achieved any 'unanticipated costs efficiencies'; the abatement level was 50% of the value of such efficiency.

Every six months, SL was required to submit a 'Financial Model' to support its revenues and costs and which could be used by the MoJ to assess whether any abatements could be justified.

The Fraud

Soon after the contracts went live, SL realized that its profit margin was much higher than the 14% originally forecast. An internal presentation indicated SL's actual margin may have been as high as 24%; however, during discussions with the MoJ concerning the extension of the contracts, the presentation shown to the government reverted to the original 14% forecast.

SL was still required to submit financial models, reporting on actual revenues and costs incurred. To reduce the reported profit margin, individuals at SL began re-charging costs from other parts of the business – including SGL – to SL. When this was no longer possible, SGL began providing invoices of £500,000 per month to SL for fabricated costs. This allowed SL to keep the reported revenue down and avoid any abatement of charges by the MoJ.

According to the judgment, internal SGL emails provided evidence of discussions about how fictitious charges should be described, as well as an awareness of the issue of abatement.

Between 2011 and 2013, a total of £11,993,699 in fabricated costs were reported by SL to the MoJ across three submitted financial models, which had the effect of reducing the reported profit margin by half against the true figures, thereby avoiding any issue of abatement of charges by the MoJ.

Directing Mind Principle

Despite the above facts, Mr Justice Davis' judgment is clear that no criminal liability is attributable to SL. He elaborates, at paragraph 18 of his judgment, with reference to the 'directing mind' principle, which, broadly speaking, is the route via which a company can be guilty of a criminal offence if an individual or individuals who can be identified as the 'directing mind' of that company were knowingly involved in the criminal act. The identification of the 'directing mind' of a company will be fact-specific. For example, it could be the board of directors or it could be one individual to whom many or all key corporate decisions are delegated through the company's articles of association.

In this case, Mr Justice Davis made clear that, although the scheme was devised by management within SL, 'no "directing mind" of SL currently can be shown to have been involved in the devising and the putting into effect of the fraud'. In contrast, according to the judge, the directing minds of SGL were party to the scheme, and so it follows that SGL – not SL – is party to the DPA.

The Agreement

The SFO alleged that SGL was guilty of a total of three offences of fraud and two offences of false accounting.

There are four main terms to the DPA which must be satisfied in order that SGL may avoid prosecution for such offences:

1. Payment of a financial penalty of £19.2 million;
2. Payment of the SFO's costs of £3,723.679;
3. Improvements to ethics and compliance policies and procedures; and
4. Continuing cooperation with the SFO and other investigative agencies.

The financial penalty was calculated by reference to the total amount of actual profit over and above the forecast 14%, multiplied by 300% in accordance with the sentencing guidelines and reduced by 50% to account for cooperation. Although it is usual to require the disgorgement of profit made from the offence, such a requirement was not imposed because Serco Group PLC had already agreed to pay £20 million to the MoJ to settle various civil claims.

Analysis

Undertakings Make Their DPA Debut

One might consider how a dormant company is able to pay significant financial penalties and costs and satisfy positive obligations to improve internal procedures.

The answer is that, effectively, it doesn't.

In a first for UK DPAs, the ultimate parent company, Serco Group PLC, provided undertakings to the SFO, to 'ensure the performance by SGL of its obligations under the Agreement' and to assume payment of the financial penalty and costs should SGL fail or be unable to meet the same.

It should be noted that in September 2018, SGL reported that its 'final contract ended on 31 January 2018 and there are no expectations to trade in the future'. In the same accounts it reported a profit of just £78,000 for the year ending December 2017.

In such circumstances, the true effect of this undertaking is that Serco Group PLC will take responsibility for the payment of the financial penalty and the SFO's costs.

Similarly, the judgment, the undertaking and the terms of the Agreement make clear that the DPA effectively extends to Serco Group PLC. The undertakings given specify that Serco Group will:

1. Where necessary and appropriate, modify its compliance program…throughout its operations, including those of SGL and its other subsidiaries.
2. Report annually to the SFO during the Term of the Agreement…with such reports satisfying SGL's obligations to report.

3. Cooperate fully with the SFO and any other domestic or foreign law enforcement or regulatory authorities throughout the Term of the Agreement.

Corporate Parental Liability or Commercial Pragmatism?

Mr Justice Davis refers to the use of such undertakings as an 'important development in the use of DPAs'. He also highlights that, due to the nature of modern corporate structures, it may be difficult to show that a parent company was criminally involved in the conduct of a subsidiary, even where the parent is the ultimate beneficiary.

Whilst undoubtedly an important development, this feature of the DPA and the above passage of the judgment suggest that parent companies who benefit from the illegal conduct of a subsidiary could ultimately be required by authorities to cover the penalties resulting from such conduct, even where that conduct cannot properly be attributed to them. That said, there may be important commercial and reputational reasons why a parent company would take a pragmatic approach in agreeing to be so held – Serco Group PLC, which has a revenue of £2.84 billion, much of which is derived from government contracts, has undoubtedly taken such an approach.

As Mr Justice Davis says himself at paragraph 42, 'it is very unlikely that the goals of a DPA could have been achieved' had Serco Group PLC not given the undertakings it gave. In the absence of such undertakings the SFO would have been faced with a decision of whether to prosecute SGL, which may have led to a criminal conviction and extensive reputational damage for Serco Group PLC.

Such PR issues would be compounded by potentially significant commercial damage to Serco Group and its other subsidiaries, including SL.

Debarment

The commercial considerations of debarment (the exclusion of companies from bidding for public contracts) are given ample attention by Mr Justice Davis. For six paragraphs he considers the proportionality of the DPA with particular reference to whether or not debarment from public contracts (for SGL, SL and/or Serco Group as a whole) would result should SGL have been successfully prosecuted.

The SFO argued that such debarment, were it to take place, would be disproportionate in light of the remedial measures taken, but that debarment might not follow were the DPA to be approved.

Mr Justice Davis rejected the SFO's suggestion that the consequence of his approval of the DPA would be that SGL could continue to supply services to the government, noting it unlikely he would give such approval: 'For me to take a course of action which would amount to a favourable determination of the position of a private company vis-à-vis public procurement would involve me in a quasi-political decision', which he stated was not a function of a judge. Following lengthy analysis, he concludes that his approval of the DPA was not the determining factor in the UK government deciding whether or not to debar Serco Group or any of its subsidiaries from providing services to the government.

This conclusion also follows the consideration of evidence from the UK Cabinet Office by way of a letter confirming there is 'no current reason why Serco should not continue to be a strategic supplier to HMG', citing the 'self-cleaning' measures adopted to date.

The Public Contracts Regulations 2015, which govern debarment in the UK, contain specific 'self-cleaning' provisions. In summary, they provide a supplementary discretion to the UK government not to exclude a company from bidding for public contracts if the company can prove that it has:

1. Paid, or undertaken to pay, compensation in respect of any damage caused by the criminal conduct;

2. Clarified the facts and circumstances in a comprehensive manner by actively collaborating with the investigating authorities; and

3. Taken concrete technical, organizational, and personnel measures to prevent further criminal conduct.

As well as crystallising the facts and circumstances of SGL's offending conduct, the judgment (and presumably the as-yet unpublished statement of facts) also points to parent company Serco Group's conduct, particularly that it agreed not to interview any witnesses during the investigation, that it gave unrestricted access to the email accounts, and that it gave some waiver of privilege in respect of accounting material.

Furthermore, the judgment makes clear that 'significant remedial measures' have been implemented by Serco Group PLC, including a complete change of senior management, the improvement of operating practices, and an earlier civil settlement with the MoJ, as referenced above.

Conclusion

In taking an expedient approach, the SFO avoided what would have been a lengthy prosecution of a dormant company which, assuming the SFO managed to achieve a conviction, would have had no money to pay a fine or costs and so would have been given an immediate discharge (as was the case with Skansen Interiors Ltd in March 2018).

In addition, Serco Group's engagement with the DPA process allowed it to retain some level of control over a scenario created by illegal practices 'ingrained' in its subsidiary, SGL.

Whilst Serco Group would have rather avoided the entire ordeal, whether or not Serco itself or its remaining subsidiaries were at risk of debarment, through its cooperation and conduct, the company has preserved its place as a key outsourcer for the UK government – all using a DPA to which it is not even a party.

Authors

This GT Alert was prepared by **Anne-Marie Ottaway**, **Barry Vitou,** and **Gareth Hall**. Questions about this information can be directed to:

- Anne-Marie Ottaway | +44 (0) 203.349.8700 | ottawayam@gtlaw.com
- Barry Vitou | +44 (0) 203.349.8700 | vitoub@gtlaw.com
- Gareth Hall | +44 (0) 203.349.8700 | hallg@gtlaw.com
- Or your Greenberg Traurig attorney

Albany. Amsterdam. Atlanta. Austin. Boca Raton. Boston. Chicago. Dallas. Delaware. Denver. Fort Lauderdale. Germany.¬ Houston. Las Vegas. London.* Los Angeles. Mexico City.+ Miami. Milan.» Minneapolis. Nashville. New Jersey. New York. Northern Virginia. Orange County. Orlando. Philadelphia. Phoenix. Sacramento. San Francisco. Seoul.∞ Shanghai. Silicon Valley. Tallahassee. Tampa. Tel Aviv.^ Tokyo.¤ Warsaw.~ Washington, D.C.. West Palm Beach. Westchester County.