

JM:JGM:PSS  
F.#2010R01934

UNITED STATES DISTRICT COURT  
EASTERN DISTRICT OF NEW YORK

- - - - -X

UNITED STATES OF AMERICA

- against -

M. No.

FALCONSTOR SOFTWARE, INC.,

Defendant.

- - - - -X

**DEFERRED PROSECUTION AGREEMENT**

The defendant FALCONSTOR SOFTWARE, INC. ("FalconStor" or "the Company"), by its undersigned attorneys, pursuant to authority granted by its Board of Directors in the form of a Board Resolution (a copy of which is attached hereto as Exhibit A), and the United States Attorney's Office for the Eastern District of New York (the "Office") hereby enter into this Deferred Prosecution Agreement (the "Agreement"). Except as specifically provided below, and in accordance with the provisions specified in paragraph 11 and 12 below, this Agreement shall be in effect for a period of 18 months.

**Complaint**

1. The United States will file a criminal complaint (the "Complaint") in the United States District Court for the Eastern District of New York charging FalconStor with a violation

of Title 18, United States Code, Section 371 for conspiracy to violate: (i) Title 18, United States Code, Section 1952(a)(3), which prohibits interstate and foreign travel and transportation in aid of unlawful activity, specifically, commercial bribery; and (ii) Title 15, United States Code, Sections 78m and 78ff, which requires securities issuers to maintain certain recordkeeping standards to ensure transactions and asset dispositions are represented fairly and accurately.

Acknowledgment of Violation of Law  
and Acceptance of Responsibility

2. FalconStor accepts and acknowledges as true the facts and allegations asserted by Special Agent Thomas McDonald in the Complaint (a copy of which is attached hereto as Exhibit B), which is incorporated herein by reference. FalconStor acknowledges and accepts that, through the conduct of certain FalconStor executives, officers and employees during the relevant time period, FalconStor is responsible for the actions set forth in the Complaint.

3. FalconStor accepts responsibility for the conduct set forth in the Complaint by entering into this Agreement and by, among other things: (a) the remedial actions that FalconStor has taken to date and will take (described in paragraph 4 below); (b) FalconStor's continuing commitment to full cooperation with the Office and the Federal Bureau of Investigation (the "FBI") (collectively, the "Investigative Entities") (described in

paragraphs 5, 6 and 7 below); (c) FalconStor's agreement to fulfill all of the undertakings FalconStor has made in this Agreement, including (i) consenting to the administrative or civil forfeiture of all right title and interest in the sum of two million, nine hundred thousand dollars (\$2,900,000.00) (the "Forfeited Sum"); and (ii) to implement or maintain enhanced internal controls as set forth herein; and (d) FalconStor's agreement to comply in the future with federal and state criminal laws.

4. FalconStor represents that its Board of Directors and current senior management have taken numerous remedial actions in response to the misconduct at FalconStor that has been discovered in various investigations. These remedial actions have included:

(a) terminating or obtaining the resignation of FalconStor officers and employees who were responsible and criminally culpable for the conspiracy to travel in aid of commercial bribery and to violate the securities laws, as set forth in the Complaint;

(b) reducing the responsibilities and compensation of other FalconStor officers and employees who were otherwise involved in the conspiracy to travel in aid of commercial bribery and to violate the securities laws, as set forth in the Complaint;

(c) making relevant organizational changes, including (i) dividing the roles of Chief Executive Officer and Chairman of the Board of Directors and (ii) creating the position of Chief of Compliance, whose appointment must be approved by the Board of Directors and who reports to the Audit Committee;

(d) revising the FalconStor Code of Conduct and Travel and Entertainment policies to, among other requirements: mandate the disclosure and clear delineation on expense reports of all gifts, travel and entertainment; prohibit all gifts to government personnel, including travel and entertainment; prohibit all gifts to non-government personnel intended to influence or obligate the recipient to do business with the Company or otherwise obtain favorable treatment; prohibit all gifts of cash or cash equivalents (e.g., gift certificates); prohibit tangible gifts over \$100 and intangible gifts (e.g., meals) over \$200; and require the provision of summaries of expense reports to the Controller of the Company;

(e) providing effective training on the FalconStor Code of Conduct and Travel and Entertainment policies, including the requirements and revisions identified in paragraph 4(d) above, to the FalconStor sales force and other relevant officers, employees and agents of the Company;

(f) requiring that proposals of equity grants to nonemployees be submitted in writing to the Compensation

Committee for approval, along with an explanation of the services provided and the written contract for services;

(g) requiring that bonuses in excess of \$25,000, including commissions outside of established employee compensation structures and other bonus-like payments, as well as all bonus or commission splits with superiors, receive prior approval from the Compensation Committee;

(h) implementing numerous additional controls, including: (i) improving accounting policies, procedures and operations; (ii) expanding finance department staffing; (iii) in addition to requiring that all contracts provide that no side deals exist that might directly or indirectly benefit the parties negotiating those contracts or their friends or relatives, now all sales people must certify the same; and (iv) training the sales force and other relevant officers, employees and agents on new and existing ethics and compliance policies; and

(i) cancelling unexercised options and the stock grants that were originally provided in connection with the commercial bribery scheme charged in the Complaint.

Continuing Obligation of Cooperation

5. FalconStor acknowledges and understands that its prior, ongoing and future cooperation is an important and material factor underlying the Office's decision to enter into this Agreement, and therefore, FalconStor agrees to continue to cooperate fully and actively with the Investigative Entities and with any other agency of the government designated by the Office (the "Designated Agencies") regarding any matter about which FalconStor has knowledge or information.

6. During the term of this Agreement, FalconStor agrees that its continuing cooperation shall include, but not be limited to, the following:

(a) completely and truthfully disclosing all information in its possession to the Investigative Entities and/or the Designated Agencies about which the Investigative Entities and/or the Designated Agencies may inquire, including but not limited to all information about activities of FalconStor, present and former members of FalconStor's Board of Directors, and FalconStor's officers, employees and agents, provided that FalconStor shall not be required, and does not intend, to waive the protection of the attorney-client privilege, attorney work-product immunity, or any other applicable privilege;

(b) assembling, organizing and providing all documents, records and other evidence in FalconStor's possession, custody or control, as reasonably may be requested by any of the Investigative Entities and/or the Designated Agencies;

(c) proactively disclosing to the Investigative Entities and/or the Designated Agencies all information concerning any additional felonies or felonious conduct beyond that specifically addressed in the attached Complaint, which has not yet been explicitly disclosed to the Investigative Entities, and which is either currently in FalconStor's possession or which may come into the possession of the senior management or Board of Directors of FalconStor in the future;

(d) using its reasonable best efforts to make available its present and former officers and employees to provide information and/or testimony as requested by the Investigative Entities and/or any of the Designated Agencies, including sworn testimony before a grand jury or in court proceedings, as well as interviews with law enforcement authorities. Cooperation under this paragraph shall include identification of witnesses who, to FalconStor's knowledge and information, may have material information concerning the conduct set forth in the Complaint. Nothing in this Agreement obligates FalconStor to indemnify or pay the costs or attorneys' fees of former officers and employees of FalconStor;

(e) providing testimony or information necessary to identify or establish the original location, authenticity or other basis for admission into evidence of documents or physical evidence in any criminal or other proceeding as requested by the Investigative Entities and/or any of the Designated Agencies, including information and testimony concerning the conduct set forth in the Complaint;

(f) with respect to any information, testimony, documents, records or physical evidence provided by FalconStor to the Investigative Entities, any of the Designated Agencies and/or a grand jury, consenting to any and all disclosures of such materials to such Designated Agencies as the Office, in its sole discretion, deems appropriate. With respect to any such materials that constitute "matters occurring before the grand jury" within the meaning of Rule 6(e) of the Federal Rules of Criminal Procedure, FalconStor further consents to: (i) any order sought by the Office permitting such disclosures; and (ii) the Office's ex parte or in camera application for such orders; and

(g) providing active assistance, including assistance by FalconStor's counsel, in connection with any investigation, criminal prosecution, civil trial or other legal proceeding brought by the Investigative Entities and/or Designated Agencies, including any proceeding seeking to obtain



disgorgement (or other similar relief) of compensation (including compensation received pursuant to any FalconStor stock option or similar plan) from any present or former FalconStor officer or employee. FalconStor and its Board of Directors will fully support efforts by the Investigative Entities to obtain disgorgement of compensation from any present or former FalconStor officer or employee who engaged in any criminal conduct while employed at FalconStor. No later than thirty (30) days after this Agreement is executed, FalconStor agrees to cancel all FalconStor shares of stock issued to Kenneth Zahner and/or Ted Zahner on or about April 6, 2010.

7. FalconStor agrees that it will continue to fulfill the cooperation obligations set forth in paragraph 6 above in connection with any investigation, criminal prosecution and/or civil proceeding brought by any of the Investigative Entities and/or Designated Entities relating to or arising out of the conduct set forth in the Complaint. FalconStor's obligation to cooperate is not intended to apply in the event that FalconStor is a defendant in any such proceeding.

Forfeiture to the United States

8. In contemplation of, and in addition to the \$2,900,000 in civil penalties to be paid by FalconStor in connection with its contemporaneous settlement with the Securities and Exchange Commission ("SEC"), FalconStor agrees to

forfeit \$2,900,000 (the "Forfeited Sum") to the United States pursuant to Title 18, United States Code, Section 981(a)(1)(C). FalconStor agrees that it will execute a Stipulation and Order forfeiting the Forfeited Sum in an administrative or civil forfeiture proceeding. FalconStor agrees to pay the Forfeited Sum according to the following schedule: \$1,160,000 within 30 days of the date of the execution of this Agreement; and \$1,740,000 within eighteen months of the date of the execution of this Agreement by certified or bank check. Said check will be hand delivered or sent by express mail to FSA Asset Forfeiture Paralegal Brian Gappa, United States Attorney's Office, Eastern District of New York, 610 Federal Plaza, Central Islip, New York 11722, with both the civil docket number and the "M-Number" assigned to this Deferred Prosecution Agreement noted on the face of the check.

9. FalconStor agrees to fully assist the government in effectuating the forfeiture of the Forfeited Sum to the United States by, among other things, executing any and all documents necessary to effectuate the immediate surrender of the Forfeited Sum to the United States. FalconStor further agrees not to file or interpose any claim, or to assist anyone else in filing or interposing a claim, to the Forfeited Sum in any judicial or administrative proceeding.

10. FalconStor agrees to release, remise and forever discharge the United States and its agencies, agents, officers, and employees, past and present, from all claims or causes of action which it or its heirs, agents, assignees, representatives, and successors ever had, now have, or hereafter may have against the United States and its agencies, agents, officers, and employees, past and present, for or on account of the incidents or circumstances giving rise to the commencement of the aforementioned civil forfeiture action, the forfeiture of the Forfeited Sum, and the settlement of the action.

11. The failure of FalconStor to forfeit the Forfeited Sum as required under this agreement, including the failure of FalconStor to execute any document to accomplish same on timely notice to do so, shall constitute a material breach of this agreement.

12. FalconStor knowingly and voluntarily waives its right to any required notice concerning the forfeiture of the Forfeited Sum. In addition, FalconStor knowingly and voluntarily waives its right, if any, to a jury trial on the forfeiture of the Forfeited Sum, and waives all constitutional, legal and equitable defenses to the forfeiture of the Forfeited Sum, including, but not limited to, any defenses based on principles of double jeopardy, the Ex Post Facto Clause of the Constitution, the statute of limitations, venue, or any defense

under the Eighth Amendment, including a claim of excessive fines. If the full amount of the Forfeited Sum is not forfeited as provided above, FalconStor shall remain liable for the balance up to the full value of the Forfeited Sum, pursuant to 21 U.S.C. § 853(p), the Federal Debt Collection Procedure Act, or any other applicable law.

13. FalconStor agrees that the forfeiture of the Forfeited Sum is not to be considered a fine or a payment on any income taxes that may be due.

14. FalconStor agrees that it will not, in connection with the Forfeited Sum, seek, obtain or accept any reimbursement or other payments or credits from any insurer of FalconStor or of any of its divisions or subsidiaries.

#### Corporate Reforms

15. FalconStor agrees: (i) that any policies, procedures or other remedial measures identified in paragraph 4 that have not already been implemented will be implemented within six months following the date of the execution of this Agreement; and (ii) that it will maintain the policies, procedures and other remedial measures identified in paragraph 4 so long as this Agreement is in effect.

#### Deferral of Prosecution

16. In consideration of FalconStor's remedial actions to date and its commitment to (a) accept and acknowledge

responsibility for its conduct, (b) continue its cooperation with the Investigative Entities and any Designated Agencies, (c) make the payments specified in paragraphs 3 and 8 above, (d) comply with federal and state criminal laws and (e) otherwise comply with all of the terms of this Agreement, the Office shall, at the time it files the Complaint, simultaneously file a joint motion pursuant to Title 18, United States Code, Section 3161(h)(2), to defer the prosecution for a period of 18 months and to obtain an exclusion of time under the Speedy Trial Act to allow FalconStor to demonstrate good conduct and compliance with the terms of this Agreement (the "\$ 3161(h)(2) Motion"). By executing this Agreement and joining in the § 3161(h)(2) Motion, FalconStor expressly waives all rights to a speedy trial pursuant to the Sixth Amendment of the United States Constitution, Title 18, United States Code, Sections 3161 et seq., Federal Rule of Criminal Procedure 48(b), and any applicable Local Rules of the United States District Court for the Eastern District of New York for the period during which this Agreement is in effect.

17. The Office agrees that, if FalconStor remains in compliance with all of its obligations under this Agreement for the 18-month period identified in paragraph 11, this Agreement shall expire, and the Office will, within 30 days of the expiration of this Agreement, move the Court pursuant to Federal

Rule of Criminal Procedure 48(a) to dismiss the Complaint with prejudice. Except in the event of a breach of this Agreement, the Office will bring no additional charges against FalconStor relating to or arising out of the matters set forth in the Complaint.

18. It is further understood that, should the Office determine that FalconStor has deliberately given materially false, incomplete or misleading information pursuant to this Agreement, has committed any federal crimes subsequent to the date of this Agreement or has otherwise knowingly, intentionally and materially violated any provision of this Agreement, FalconStor thereafter shall be subject to prosecution for any Federal criminal violation of which the Office has knowledge. Any such prosecution may be premised on any information provided by or on behalf of FalconStor to the Investigative Entities and/or any of the Designated Agencies at any time. Moreover, FalconStor agrees that the statute of limitations with respect to any prosecution relating to the allegations in the Complaint is not time-barred as of the date of this Agreement shall be tolled for the term of this Agreement plus one year. By this Agreement, FalconStor expressly intends to and does waive any rights in this respect. Such waiver is knowing, voluntary and in express reliance on the advice of FalconStor's counsel.

19. It is further agreed that, in the event that the Office determines that FalconStor has knowingly, intentionally and materially violated any provision of this Agreement:

(a) all statements made by or on behalf of FalconStor or any of its officers, directors or employees to the Office, including its admission that the facts set forth in the Complaint are true and accurate, the FBI, the SEC, the New York District Attorney's Office and/or any of the Designated Agencies, and/or any testimony given by FalconStor or any of its officers, directors or employees before a grand jury or elsewhere, whether before or after the date of this Agreement, and any leads derived from such statements or testimony, shall be admissible in evidence in any and all criminal proceedings brought by the Office against FalconStor; and

(b) FalconStor shall not assert any claim under the United States Constitution, Rule 11(f) of the Federal Rules of Criminal Procedure, Rule 410 of the Federal Rules of Evidence or any other statute or federal rule that statements made by or on behalf of FalconStor before or after the date of this Agreement, or any leads derived therefrom, should be suppressed; and

(c) FalconStor waives any right it may have to have the criminal conduct set forth in the Complaint presented to a grand jury and agrees to be charged by an Information.

This waiver is knowing, voluntary and in express reliance on the advice of FalconStor's counsel.

20. FalconStor agrees that it shall not, through its attorneys, Board of Directors, agents, officers or employees, make any public statement, in litigation or otherwise, contradicting its acceptance of responsibility or the allegations set forth in the Complaint. Any such contradictory statement by FalconStor, its present or future attorneys, Board of Directors, agents, officers or employees shall constitute a breach of this Agreement, and FalconStor thereafter shall be subject to prosecution as specified in paragraphs 16 to 19. The decision as to whether any such contradictory statement will be imputed to FalconStor for the purpose of determining whether FalconStor has breached this Agreement shall be at the sole discretion of the Office. Upon the Office's notifying FalconStor of any such contradictory statement, FalconStor may avoid a finding of a breach of this Agreement by publicly repudiating such statement within three business days after receipt of notice by the Office. This Paragraph is not intended to apply to any statement made by any current or former FalconStor officer, director or employee who is or has been charged with a crime or other wrongdoing by the government or an agency thereof.



21. FalconStor agrees that the decision whether conduct and/or statements of any individual will be imputed to FalconStor for the purpose of determining whether FalconStor has knowingly, intentionally and materially violated any provision of this Agreement shall be in the sole discretion of the Office, provided, however, that the statements of any former officer, director or employee of FalconStor shall not be attributed to FalconStor for such purpose. Should the Office determine that FalconStor has committed a knowing, intentional and material breach of any provision of this Agreement, the Office shall provide written notice of the alleged breach to FalconStor, addressed to its General Counsel and to FalconStor's counsel, Alan Vinegrad, Esq. of Covington & Burling LLP, or to any successor that FalconStor may designate, and provide FalconStor with a two-week period from the date of receipt of such notice in which to make a presentation to the Office, or its designee, to demonstrate that no breach has occurred, or, to the extent applicable, that the breach was not knowing, intentional or material, or has been cured. Upon request by FalconStor, the Office may agree in writing to extend this two-week period, including to provide FalconStor with an opportunity to cure any breach of this Agreement. The parties to this Agreement expressly understand and agree that should FalconStor fail to make a presentation to the Office, or its designee, within the

two-week period (or other period agreed to by the Office), the Office may conclusively presume that FalconStor is in knowing, intentional and material breach of this Agreement. The parties further understand and agree that the exercise of discretion by the Office or its designee under this paragraph is not subject to review in any court or tribunal or any other office within the United States Department of Justice.

22. Except to the extent permitted by the Office, FalconStor agrees that, if it sells or merges all or substantially all of its business operations as they exist as of the date of this Agreement to, or into, a single purchaser or group of affiliated purchasers during the term of this Agreement, FalconStor shall include in any contract for sale or merger a provision binding the purchaser/successor to FalconStor's obligations described in this Agreement; provided, however, that the obligations imposed by this Agreement will not extend to the governance or operation of a purchasing or investing entity that acquires some or all of FalconStor's stock, so long as that entity maintains FalconStor as a separate corporate entity.

23. It is understood that this Agreement is binding on FalconStor and the Office, but specifically does not bind any other Federal agencies, any state or local law enforcement agencies, any licensing authorities or any regulatory

authorities. However, if requested by FalconStor or its attorneys, the Office will bring to the attention of any such agencies, including but not limited to any licensing authorities, the Agreement, the cooperation of FalconStor and its compliance with its obligations under this Agreement, and any corporate reforms specified in this Agreement. It is the intent of the parties to this Agreement that the Agreement does not confer or provide any benefits, privileges or rights to any individual or other entity other than the parties hereto, and that nothing in the Agreement shall be construed as acknowledging that the Agreement, including the Complaint and the evidence underlying the Agreement or Complaint, shall be admissible in any proceeding other than a proceeding brought by the Office. Moreover, FalconStor may raise defenses and/or assert affirmative claims in any civil proceedings brought by private parties as long as doing so does not otherwise violate any term of this Agreement.

24. FalconStor and the Office agree that, upon the filing of the Complaint in accordance with paragraphs 1 and 16, this Agreement (including its attachments) shall be publicly filed in the United States District Court for the Eastern District of New York.

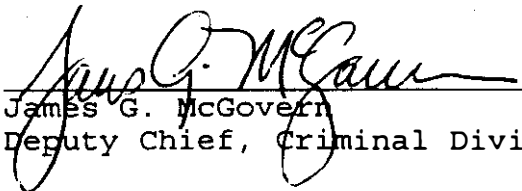
25. This Agreement sets forth all the terms of the Deferred Prosecution Agreement between FalconStor and the

Office. No modifications or additions to this Agreement shall be valid unless they are in writing and signed by the Office, FalconStor's attorneys and a duly authorized representative of FalconStor.

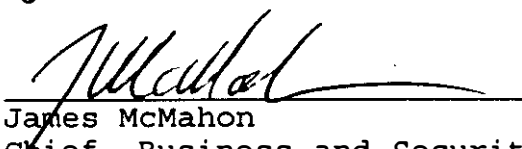
Dated: Brooklyn, New York  
June 27, 2012

LORETTA E. LYNCH  
United States Attorney  
Eastern District of New York

By:

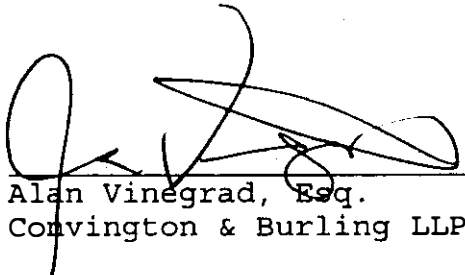
  
James G. McGovern  
Deputy Chief, Criminal Division

By:

  
James McMahon  
Chief, Business and Securities  
Fraud Unit

AGREED AND CONSENTED TO BY:

Eli Oxenhorn  
Chairman of the Board of Directors  
FALCONSTOR SOFTWARE, INC., Defendant

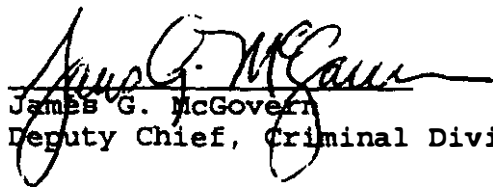
  
Alan Vinegrad, Esq.  
Convington & Burling LLP

Office. No modifications or additions to this Agreement shall be valid unless they are in writing and signed by the Office, FalconStor's attorneys and a duly authorized representative of FalconStor.


Dated: Brooklyn, New York  
June 27, 2012

LORETTA E. LYNCH  
United States Attorney  
Eastern District of New York


By:


  
James G. McGovern  
Deputy Chief, Criminal Division

By:

  
James McMahon  
Chief, Business and Securities  
Fraud Unit

AGREED AND CONSENTED TO BY:

  
Eli Oxenhorn  
Chairman of the Board of Directors  
FALCONSTOR SOFTWARE, INC., Defendant

  
Alan Vinegrad, Esq.  
Convington & Burling LLP

RESOLUTION  
OF  
FALCONSTOR SOFTWARE, INC.

I, Seth R. Horowitz, Secretary of FalconStor Software, Inc. hereby certify that the following resolutions were duly enacted at a meeting of the Board of Directors of FalconStor Software, Inc. held on April 10, 2012.

RESOLVED, that the Company enter into the Deferred Prosecution Agreement and related agreements to settle the investigation by the United States Department of Justice; and it was further

RESOLVED, that Eli Oxenhorn be authorized to sign all necessary documents on behalf of the Company to effectuate the settlement and it was further

\* \* \*

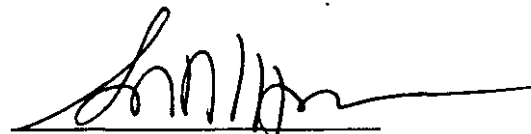
RESOLVED, that the authorized officers of the Company be, and each of them they hereby is, authorized, empowered and directed for and on behalf of the Company to take (or cause to be taken) any and all action, to execute, file and deliver (or cause to be executed, filed or delivered) any and all documents, certificates, instructions, requests or other instruments, and to do any and all things which such officers may deem necessary, proper, convenient or desirable in order to carry out and effectuate the intent and purposes of each of the foregoing resolutions, and that all actions taken (or caused to be taken) by the officers of the Company prior to the date of these resolutions, in connection with the actions contemplated by the foregoing resolutions or otherwise be, and they hereby are, confirmed, ratified and approved in all respects.

I further certify that the aforesaid resolution has not been amended or revoked in any respect and is still in full force and effect.

FalconStor Software, Inc.

Dated: June 19, 2012

By:

A handwritten signature in black ink, appearing to read 'Seth R. Horowitz', written over a horizontal line.

Seth R. Horowitz  
Vice President, General Counsel &  
Secretary  
FalconStor Software, Inc.  
2 Huntington Quadrangle  
Suite 2S01  
Melville, NY 11747