

## DISGORGEMENT ACCOUNTING AFTER *LIU V. SEC* IN SECURITIES ENFORCEMENT CASES

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### ABSTRACT

*In Liu v. SEC, the Supreme Court determined that disgorgement remedies for the Securities and Exchange Commission (SEC) civil penalties shall be limited to the defendant's "net profits." This holding changes the calculus for award determinations in billions worth of corporate and individual defendant settlements with the SEC every year.*

*Much of the back and forth in those negotiations has been felt in private settlement conferences with the SEC, where many defendants make individual arguments about the limits on a disgorgement penalty using accounting expertise. This is the first Article to systematically link the precedent and guidance available in the remedies treatises cited by the Supreme Court in Liu and in related lower court opinions expanding on Liu and to then link those concepts to fundamental accounting and finance principles.*

*The result is an Article at the intersection of securities law and accounting that links those two literatures together to contribute to the law and accounting literature generally. This Article further serves as a guide for the SEC and defendants in shaping the billions of dollars in disgorgement remedies that those parties negotiate every year.*

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I. INTRODUCTION TO *LIU V. SEC* AND THE DISGORGEMENT REMEDY

Disgorgement awards represent a sizable portion of annual awards paid to the Securities and Exchange Commission (SEC) in judgments and settlements and, in many years, represent most of the amounts collected by the SEC. SEC disgorgement penalties were \$2.2 billion in 2022, \$2.4 billion in 2021, \$3.6 billion in 2020, and \$3.2 billion in 2019.<sup>1</sup> By way of context, in 2019, the SEC received \$4.3 billion in total awards, of which \$3.2 billion was a result of disgorgement remedies.<sup>2</sup> In more recent years, disgorgement awards range from three-quarters to one-third of total SEC enforcement awards.<sup>3</sup>

<sup>1</sup> See Div. of Enf't, Sec. & Exch. Comm'n, Addendum to Division of Enforcement Press Release: Fiscal Year 2021, at 2 (2021); Div. of Enf't, Sec. & Exch. Comm'n, Addendum to Division of Enforcement Press Release: Fiscal Year 2022, at 2 (2022).

<sup>2</sup> See Jennifer J. Schulp, *Liu v. SEC: Limiting Disgorgement, but by How Much?*, 19 CATO SUP. CT. REV. 203, 203 (2020).

<sup>3</sup> See Div. of Enf't, Sec. & Exch. Comm'n, Addendum to Division of Enforcement Press Release: Fiscal Year 2023, at 2 (2023).

The SEC is authorized by statute to seek disgorgement in administrative proceedings.<sup>4</sup> The SEC is also authorized to seek equitable relief in civil actions,<sup>5</sup> which the Supreme Court interpreted in *Liu v. SEC* as equivalent to a disgorgement remedy.<sup>6</sup> These remedies, originally described as “restitution” in case law but later described as “disgorgement,” provide the basis for relief sought by the SEC, in conformity with the limits set in *Liu*.<sup>7</sup>

The Supreme Court determined in *Liu* that a disgorgement award must be limited to the net profits gained from a securities law violation, and the calculation for that award should take into account the legitimate expenses that “have value independent of fueling a fraudulent scheme.”<sup>8</sup> *Liu* holds that defendants are allowed to deduct legitimate expenses in determining the disgorgement award, but excludes some categories of illegitimate expenses, such as excessive salaries.<sup>9</sup>

For our purposes, the principal holding in *Liu* was that the disgorgement remedy would be limited to “net profits.”<sup>10</sup> The Court did mention that in cases where the entirety “of a business or undertaking’ result[ed] from . . . wrongful activity,” the defendant would not be allowed to offset the disgorgement award with “claims for personal services or . . . inequitable deductions.”<sup>11</sup>

This is consistent with prior cases that have refused to allow deductions for what appears to the court to be excessive compensation to the individuals who perpetrated a fraud.<sup>12</sup> But other than instances in which a claimed expense was bogus or where the expense was a tainted expense that itself furthered the fraud, the Supreme Court held that even wrongdoers are permitted to deduct legitimate expenses from a disgorgement award.<sup>13</sup>

There are statutory construction arguments discussing whether or not language included in the National Defense Authorization Act of 2021—which provided the SEC explicit authority to seek disgorgement—may have altered the holdings in *Kokesh v. SEC* and

<sup>4</sup> *Liu v. SEC*, 591 U.S. 71, 75 (2020) (discussing 15 U.S.C. § 77h-1(e)).

<sup>5</sup> *Id.* (discussing 15 U.S.C. § 78u(d)(5)).

<sup>6</sup> *Id.*

<sup>7</sup> See *id.* at 75–77 (first quoting *SEC v. Tex. Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971); and then quoting *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90 (2d Cir. 1978)).

<sup>8</sup> See *Liu*, 591 U.S. at 91–92 (citing *Rubber Co. v. Goodyear*, 76 U.S. 788 (1869)).

<sup>9</sup> See *Liu*, 591 U.S. at 84, 91–92 (citing *Goodyear*, 76 U.S. 788).

<sup>10</sup> *Liu*, 591 U.S. at 75.

<sup>11</sup> *Id.* at 84 (quoting *Root v. Ry. Co.*, 105 U.S. 189 (1882)).

<sup>12</sup> See, e.g., *SEC v. JT Wallenbrock & Assocs.*, 440 F.3d 1109, 1117 (9th Cir. 2006); see also *Kokesh v. SEC*, 581 U.S. 455, 467 (2017); *Goodyear*, 76 U.S. at 804.

<sup>13</sup> See *Liu*, 591 U.S. at 92 (quoting *Root*, 105 U.S. 189; *Goodyear*, 76 U.S. 788).

later *Liu*.<sup>14</sup> Jason R. Chohonis, for example, asks whether the recent statutory authorization to bring disgorgement actions after *Liu* will have any impact on the limitations on disgorgement resulting from *Liu*.<sup>15</sup>

Thus far, courts have upheld the net profits limitation noted in *Liu*, and this Article will continue to work from the assumption that the limitation applies. For example, in *SEC v. Hallam*,<sup>16</sup> the court found that even in instances where the SEC uses disgorgement powers arising solely from the statute, the SEC is nevertheless bound to the basic analysis in *Liu* for determining gross profits, permitted expense deductions, and ultimate disgorgeable net profits.<sup>17</sup>

In *Liu*, the Supreme Court noted that historical interpretations frequently use the terms *disgorgement* and *accounting* interchangeably,<sup>18</sup> which suggests that interpreting both phrases can be useful in understanding the post-*Liu* boundaries of disgorgement. The Court in *Liu* used the history of disgorgement awards in patent litigation as one guide to interpreting the remedy's limits.<sup>19</sup> This Article will explore that precedent as well. The law of disgorgement is well developed in a number of other areas of law, including other intellectual property related fields and in general fraud actions.<sup>20</sup> This Article draws from all of those rich bodies of precedent to develop the contours of the net profits limitation on disgorgement actions.

The Supreme Court in *Liu* explicitly stated that equitable remedies like disgorgement “can be discerned by consulting works on equity jurisprudence” such as the Restatement (Third) of Restitution and Unjust Enrichment, later referenced in the *Liu* opinion.<sup>21</sup> This

<sup>14</sup> E.g., Jason R. Chohonis, Comment, *Patching the Holes in SOX: FCPA Disgorgement After Liu and the NDAA*, 71 EMORY L.J. 841, 876–77, 878–81, 882–86 (2022).

<sup>15</sup> *Id.* at 879.

<sup>16</sup> *SEC v. Hallam*, 42 F.4th 316 (5th Cir. 2022).

<sup>17</sup> *See id.* at 341–43.

<sup>18</sup> *Liu*, 591 U.S. at 81 (citing *SCA Hygiene Prods. Aktiebolag v. First Quality Baby Prods., LLC*, 580 U.S. 328 (2017)).

<sup>19</sup> *See Liu*, 591 U.S. at 79–82 (citing *Root v. Ry. Co.*, 105 U.S. 189 (1882); *Tilgham v. Proctor*, 125 U.S. 136 (1888); *Porter v. Warner Holding Co.*, 328 U.S. 395 (1946); *Petrella v. Metro-Goldwyn-Mayer, Inc.*, 572 U.S. 663 (2014); *Tull v. United States*, 481 U.S. 412 (1987); *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204 (2002); *Kansas v. Nebraska*, 574 U.S. 445 (2015); *SCA Hygiene Prods. Aktiebolag*, 580 U.S. 328; *Romag Fasteners, Inc. v. Fossil Grp., Inc.*, 590 U.S. 212 (2020)).

<sup>20</sup> David Levintow, Note, *Down, but Not Out: After Liu, Disgorgement Challenges for the SEC in FCPA Enforcement*, 28 PIABA BAR J. 179, 189 (2021); *see also Liu*, 591 U.S. at 81, 82–83 (first citing *SCA Hygiene Prods. Aktiebolag*, 580 U.S. 328; and then citing *Ambler v. Whipple*, 87 U.S. 546 (1874)).

<sup>21</sup> *See Liu*, 591 U.S. at 79–80 (first citing *Great-West Life & Annuity Ins. Co.*, 534 U.S. 204; and then citing RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (AM. L. INST. 2011)).

Article will carefully dissect this particular Restatement as the best source available to guide practitioners through the open questions left by *Liu* in a disgorgement calculation of net profits. The Court also cited the Law of Remedies and Equity Jurisprudence, another secondary source that proves useful in guiding interpretive questions about the contours of post-*Liu* disgorgement remedies.<sup>22</sup>

Jennifer J. Schulp, the Cato Institute's Director of Financial Regulation Studies, sums up the disgorgement process left by the *Liu* holding succinctly:

Courts generally require the SEC to distinguish between legally and illegally obtained profits and identify the causal link between the unlawful activity and profit to be disgorged. But because these calculations are logistically difficult to verify, courts have said that the SEC needs to proffer only a “reasonable approximation of profits causally connected to the violation,” and then the burden shifts to the defendant to disprove the SEC’s calculation.<sup>23</sup>

Schulp previews the prospective difficulties with determining legitimate and deductible expenses in disgorgements, noting that “[t]his fact-intensive inquiry will raise a host of interpretive questions about deductibility of expenses. Some of these questions may be answered by analogy to precedent, but many will be questions of first impression.”<sup>24</sup>

In *SEC v. De Maison*,<sup>25</sup> the Second Circuit summarized the burden process in a disgorgement award.<sup>26</sup> First, the SEC must make “a reasonable approximation of profits causally connected to the violation,” and the risk of uncertainty in that calculation falls on the wrongdoer.<sup>27</sup> Once the SEC has made a reasonable approximation, then the burden shifts to the defendant.<sup>28</sup> Though technically a pre-*Liu* framework focused on total proceeds from a fraud,<sup>29</sup> the Fifth

<sup>22</sup> *Liu*, 591 U.S. at 79.

<sup>23</sup> Schulp, *supra* note 2, at 203 n.\*, 207–08.

<sup>24</sup> *See id.* at 222.

<sup>25</sup> *SEC v. de Maison*, 785 F. App’x 3 (2d Cir. 2019).

<sup>26</sup> *See id.* at 6 (quoting *SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014)).

<sup>27</sup> *de Maison*, 785 F. App’x at 6 (quoting *Contorinis*, 743 F.3d 296).

<sup>28</sup> *See de Maison*, 785 F. App’x at 6 (quoting *Contorinis*, 743 F.3d 296).

<sup>29</sup> *See de Maison*, 785 F. App’x at 6–7 (quoting *Contorinis*, 743 F.3d 296); *see also* *Liu v. SEC*, 591 U.S. 71 (2020).

Circuit has utilized the same burden-shifting to analyze net profits post-*Liu* in *Hallam*.<sup>30</sup>

This Article provides clarity to existing precedent in order to offer an accounting framework for defendants to harness accounting principles and meet that burden. This framework draws not only from financial accounting, but also from cost and other accounting methods. By joining together securities law analysis with forensic and cost accounting analysis, this Article sketches out some of these very interpretive questions while providing some direction as to how they can be answered by the courts that will subsequently interpret the contours of *Liu*. Then, the framework provided by this Article will more often be useful to counsel in settlement negotiations with the SEC aimed at resolving issues before litigation commences.

Finally, this Article ultimately develops two frameworks: one for both securities lawyers and forensic accountants to use in submissions made during negotiations with the SEC; and two, a framework for expert reports submitted either in court proceedings or before SEC Administrative Law Judges when a disgorgement remedy is anticipated.

## II. PART ONE OF THE *LIU* TEST: DETERMINING TAINTED REVENUE

The initial question in a disgorgement accounting will be to identify the revenues tainted due to fraud or other securities law violation.<sup>31</sup> These revenues generated from the wrongdoing are separated from revenues legitimately earned.<sup>32</sup>

This initial step also may require apportionment of revenues between related parties, as in circumstances where parent- and partly-owned subsidiaries are involved in the action or where individuals and entities are combined as defendants in an action.<sup>33</sup> It may then become necessary to determine which parties were the recipient of what share of tainted revenue,<sup>34</sup> which may present complicated questions.

The first step in a disgorgement accounting may seem like it would invoke a tracing analysis like that seen in the 1933 Securities Act

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<sup>30</sup> See *SEC v. Hallam*, 42 F.4th 316, 329 (5th Cir. 2022) (quoting *SEC v. First City Fin. Corp.*, 890 F.2d 1215 (D.C. Cir. 1989)).

<sup>31</sup> See *Liu*, 591 U.S. at 79.

<sup>32</sup> See *id.* at 84.

<sup>33</sup> See *id.* at 90 (quoting *Belknap v. Schild*, 161 U.S. 10 (1896)).

<sup>34</sup> See *Liu*, 591 U.S. at 83 (citing *Belknap*, 161 U.S. 10; *Keystone Mfg. Co. v. Adams*, 151 U.S. 139 (1894); *Jennings v. Carson*, 8 U.S. 2 (1807)).

Section 11 and Section 12(a)(2) cases.<sup>35</sup> But courts have ruled otherwise.

In *SEC v. Camarco*,<sup>36</sup> the court held that once it has been determined that tainted money has been received, the SEC is not required to trace the individual funds to their current location.<sup>37</sup> The defendant does not need to still be in possession of the funds wrongfully obtained at the time of disgorgement.<sup>38</sup> This is considered a separate aspect from the ability to deduct legitimate expenses from the disgorgeable award.<sup>39</sup>

The court in *Camarco* also found that a proper disgorgement award must distinguish between tainted and untainted funds.<sup>40</sup> In other words, a bad actor's receipt of tainted funds in a securities fraud is different from the receipt of legitimate compensation, which is untainted.<sup>41</sup> The court noted that to hold otherwise may work to impose joint and several liability, which is not permitted under *Liu*.<sup>42</sup>

In *Hallam*, the court referenced the Tenth Circuit's conclusion in *Camarco*, which rejected any tracing requirement in a disgorgement calculation by holding that the SEC is merely held to a standard of only a "reasonable approximation of profits."<sup>43</sup> Nevertheless, the court in *Camarco* also indicated there may be circumstances in the

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<sup>35</sup> See, e.g., *Jensen v. iShares Trust*, 258 Cal. Rptr. 3d 1, 10–11, 19 (Cal. Ct. App. 2020) (quoting *Petzschke v. Century Aluminum Co.*, 729 F.3d 1104 (9th Cir. 2012)); *Pirani v. Slack Techs., Inc.*, 13 F.4th 940, 946, 949 (9th Cir. 2021) (first quoting *Pinter v. Dahl*, 486 U.S. 622 (1988); then quoting *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995); and then citing *Hertzberg v. Dignity Partners*, 191 F.3d 1076 (9th Cir. 1999)). See generally Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429 (2000). The Securities Act of 1933 "create[s] financial transparency in the capital markets by requiring companies to make significant initial and ongoing disclosures." Sale, *supra*, at 430. "Section 11 provides purchasers of a registered security with a claim against enumerated defendants for material misstatements or omissions in the registration statement," while "Section 12(a)(2) [provides] an express, negligence-like cause of action for misstatements or omissions in a 'prospectus or oral communication' made in connection with the sale or offer for sale of a security." *Id.* at 433–34, 437–48. A tracing analysis "refer[s] to the judicially created requirement that to access [S]ections 11 and 12(a)(2)[.] shareholders must plead and prove that they bought shares issued either 'in' the public offering for which the registration statement or prospectus was issued, or 'pursuant to' that offering. . . . Accordingly, unless the shareholders' securities are connected to the registration statement, or prospectus or oral communication on which they are suing, the shareholders do not have standing to bring a case under either section." *Id.* at 440–41.

<sup>36</sup> *SEC v. Camarco*, No. 19-1486, 2021 WL 5985058 (10th Cir. Dec. 16, 2021).

<sup>37</sup> *Id.* at \*14.

<sup>38</sup> See *id.* at \*17.

<sup>39</sup> See *id.* at \*15 (quoting *SEC v. World Capital Mkt., Inc.*, 864 F.3d 996 (2017)).

<sup>40</sup> *Camarco*, 2021 WL 5985058, at \*18 (citing *World Cap. Mkt., Inc.*, 864 F.3d 996).

<sup>41</sup> See *Camarco*, 2021 WL 5985058, at \*18 (citing *World Cap. Mkt., Inc.*, 864 F.3d 996).

<sup>42</sup> See *Camarco*, 2021 WL 5985058, at \*18 (citing *Liu v. SEC*, 591 U.S. 71 (2020)).

<sup>43</sup> See *SEC v. Hallam*, 42 F.4th 316, 335–36 (5th Cir. 2022) (quoting *Camarco*, 2021 WL 5985058).

future where it may be required to conduct a tracing analysis to determine disgorgeable amounts.<sup>44</sup>

A reading of *Hallam* and *Camarco* reveals that while funds must be divided into tainted and untainted amounts on their way into an organization or individual responsible for fraud, the pool of funds itself available for recovery need not be traced to specific portions of the assets available for disgorgement.<sup>45</sup> In short, this suggests a focus on the analysis of the income statement rather than of the balance sheet.<sup>46</sup> It will be relevant to track incoming revenues that are either tainted or not tainted (and outgoing expenses if they are deemed legitimate). It will not, however, be a relevant exercise to try to determine whether currently held assets or distributed assets are the tainted assets. Nor will it be relevant to attempt tracing where cash or other assets on the balance sheet originated. Even so, one exception, unrelated to tracing income, when the balance sheet may be germane to the analysis, would be in instances where a subsidiary is implicated in an enforcement action and valuation methods are utilized.<sup>47</sup>

The Court in *Liu* held that disgorgement could not be applied against multiple wrongdoers through some sort of joint and several liability; instead, it must be applied individually.<sup>48</sup> Thus, step one of a *Liu* disgorgement analysis needs to apportion revenue and expenses that appear to be borne by multiple parties or entities. The case of *ABKCO Music, Inc. v. Harrisongs Music, Ltd.*<sup>49</sup> explores a number of methods to apportion profits by utilizing the testimony of

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<sup>44</sup> See *Camarco*, 2021 WL 5985058, at \*16.

<sup>45</sup> See *Hallam*, 42 F.4th at 342; *Camarco*, 2021 WL 5985058, at \*17.

<sup>46</sup> See *3 Financial Statements to Measure a Company's Strength*, SCHWAB (Feb. 13, 2023), <https://www.schwab.com/learn/story/3-financial-statements-to-measure-companys-strength> [<https://perma.cc/GQK3-WXS8>] (“While the income statement is a record of the funds flowing in and out of a company over a given time period, the consolidated balance sheet is a snapshot of a company’s financial position at a given point in time. In other words, the balance sheet shows what a company owns (its assets) and owes (its liabilities) and the difference between the two (stockholders’ equity).”).

<sup>47</sup> See PWC, FINANCIAL STATEMENT PRESENTATION 31-4 (2024) (“In parent company financial statements, the net carrying amount of a subsidiary attributable to the parent should equal the amount reported in the parent company’s balance sheet as its investment in the underlying net assets of the subsidiary measured using the parent’s basis less any noncontrolling interest.”); CLIFFORD CHANCE, RECENT SEC ENFORCEMENT ACTIONS HIGHLIGHT THE IMPORTANCE OF SOUND VALUATION AND DISCLOSURE PRACTICES BY INVESTMENT MANAGERS 1 (2020) (noting that “recent developments underscore the SEC’s continued focus on ensuring that investment managers accurately value portfolio holdings and clearly and accurately disclose fund and manager performance”).

<sup>48</sup> See *Liu v. SEC*, 591 U.S. 71, 83 (2020) (citing *Ambler v. Whipple*, 87 U.S. 546, 559 (1874)).

<sup>49</sup> *ABKCO Music, Inc. v. Harrisongs Music, Ltd.*, 508 F. Supp. 798 (S.D.N.Y. 1981), *aff’d*, 722 F.2d 988 (2d Cir. 1983).

experts in the context of apportioning the revenue and expenses of a song production that was partially plagiarized.<sup>50</sup>

An apportionment process along the lines of that conducted in *ABKCO* may be viewed as, effectively, a sub-element of both determining attributable revenue and determining legitimate and deductible expenses, as explored below in the discussion of step two.

In effect, two tests in a post-*Liu* analysis build on the framework found in pre-*Liu* cases like *Camarco*. The first test considers whether revenue is tainted. If it is tainted, subsequent transfers of that revenue will not limit the liability of the recipient. Then, in a second stage of analysis, legitimate expenses may be deducted from the tainted revenue to reduce a disgorgement award.<sup>51</sup> For cases in which trading is involved, losses are netted against gains to arrive at a disgorgement award.<sup>52</sup>

Pre-*Liu* courts have ruled that earnings on the proceeds of ill-gotten gains are not disgorgeable<sup>53</sup>—rulings that should survive *Liu*. If ill-gotten proceeds are invested and read as a windfall gain for the wrongdoer, those gains are not disgorgeable—only the originally ill-gotten gains are disgorgeable (net of expenses).<sup>54</sup>

The following section will explore case law guidance on how to conduct the second stage of a *Liu* disgorgement accounting analysis in estimating legitimate and deductible expenses.

### III. PART TWO OF THE *LIU* TEST: DETERMINING LEGITIMATE EXPENSES

There are two lines of inquiry regarding the second half of the *Liu* test on expenses: whether the expenses (1) are legitimate and connected to the revenue subject to disgorgement, and (2) “have value independent of fueling a fraudulent scheme.”<sup>55</sup> The expenses need to be related to the tainted revenue, but not so closely connected that the expenses can be seen as furthering the fraud or otherwise having no value independent of furthering the fraud.

<sup>50</sup> See *ABKCO Music, Inc.*, 508 F. Supp. at 799–802.

<sup>51</sup> See *SEC v. Hallam*, 42 F.4th 316, 330 (5th Cir. 2022) (quoting *Liu*, 591 U.S. 71); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. h (AM. L. INST. 2011).

<sup>52</sup> See, e.g., *SEC v. Nadel*, 206 F. Supp. 3d 782, 786 (E.D.N.Y. 2016).

<sup>53</sup> See, e.g., *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1104 (2d Cir. 1972); see also *SEC v. Razmilovic*, 738 F.3d 14, 35 (2d Cir. 2013).

<sup>54</sup> See James Tyler Kirk, *Deranged Disgorgement*, 8 BUS., ENTREPRENEURSHIP, & L. 131, 170–71 (2014).

<sup>55</sup> *Liu*, 591 U.S. at 91–92.

Bribes paid as part of a Foreign Corrupt Practices Act (FCPA) violation would not be deductible,<sup>56</sup> because they do not “have value independent of fueling a fraudulent scheme.” Expenses at a subsidiary in a different line of business from a subsidiary where fraudulent financial reporting has taken place would not be deductible because they are not incurred in producing the revenues subject to the disgorgement.

James Tyler Kirk, an SEC attorney, writes that some of the confusion courts have experienced with disgorgement is that they mix up the concept of *net profits* with *gross proceeds*.<sup>57</sup> The court in *Liu* clearly chose to use a net profits calculation.<sup>58</sup> It appears that pre-*Liu* cases may have been confused about the difference between net profits and gross proceeds,<sup>59</sup> and their focus on net proceeds is no longer good precedent for that position.<sup>60</sup>

There are a few pre-*Liu* cases analyzing deductible expenses in a disgorgement calculation. *SEC v. Thomas James Associates, Inc.*<sup>61</sup> may provide one of the more helpful guides for discerning which expenses are and are not deductible as a case that thoroughly addressed the question and was among those favorable to legitimate expenditure deductions from disgorgement awards before *Liu* made that practice mandatory.<sup>62</sup>

*SEC v. Bronson*<sup>63</sup> held that, in the context of illicit transactions, an individual’s direct costs, such as brokerage commissions or transfer taxes and fees, are deductible.<sup>64</sup> A pre-*Liu* Second Circuit decision, *SEC v. Rosenfeld*,<sup>65</sup> held that an individual defendant’s transaction fees, such as brokerage costs, could be offset against a disgorgement award.<sup>66</sup> Cases involving individual traders are less complex to interpret post-*Liu* because their expenses generally are simple transaction fees, whereas company defendants have more varied

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<sup>56</sup> Transcript of Oral Argument at 32–33, *Liu*, 591 U.S. 71 (No. 18-1501), 2020 WL 1033201, at \*32–33.

<sup>57</sup> Kirk, *supra* note 54, at 131 n.\*, 158–60.

<sup>58</sup> See *Liu*, 591 U.S. at 75.

<sup>59</sup> See Kirk, *supra* note 54, at 159, 160 n.136 (citing *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978); *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082 (2d Cir. 1972)).

<sup>60</sup> See, e.g., *Manor Nursing Ctrs., Inc.*, 458 F.2d at 1104.

<sup>61</sup> *SEC v. Thomas James Assocs., Inc.*, 738 F. Supp. 88 (W.D.N.Y. 1990).

<sup>62</sup> See *id.* at 94–95.

<sup>63</sup> *SEC v. Bronson*, 246 F. Supp. 3d 956 (S.D.N.Y. 2017).

<sup>64</sup> See *id.* at 976 (quoting *SEC v. McCaskey*, No. 98 Civ. 6153, 2002 WL 850001 (S.D.N.Y. Mar. 26, 2002)).

<sup>65</sup> *SEC v. Rosenfeld*, No. 97 Civ. 1467, 2001 WL 118612 (S.D.N.Y. Jan. 9, 2001).

<sup>66</sup> See *id.* at \*2 (citing *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb*, 734 F. Supp. 1071 (S.D.N.Y. 1990)).

operational expenses, subdivided into categories of fixed and variable expenses.<sup>67</sup>

The language in *Liu* refers to legitimate and deductible expenses as *marginal*.<sup>68</sup> It would be a mistake to interpret too much meaning from that adjective. On its face, *marginal expenses* would seem to mean variable expenses that match closely with revenues and not fixed overhead expenses.<sup>69</sup> Yet, that singular adjective *marginal* should not be read so strictly. A prior case consistent with *Liu*, *Rubber Co. v. Goodyear*, which is cited by the Supreme Court in *Liu*,<sup>70</sup> and the SEC's own filings on remand in *Liu*, all accept that some fixed overhead costs are legitimately deductible in disgorgement accounting.<sup>71</sup>

In *Kars 4 Kids Inc. v. America Can!*,<sup>72</sup> the court allowed the deduction of “management compensation, labor, and office expenses.”<sup>73</sup> In *Thomas James Associates, Inc.*, the SEC permitted the deduction of overhead expenses that did not directly contribute to fraud.<sup>74</sup> This focus on overhead suggests that cost accounting methodologies utilized outside of Generally Accepted Accounting Principles (GAAP)<sup>75</sup> might prove relevant in disgorgement net profit accounting.

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<sup>67</sup> See Barclay Palmer, *Institutional Investors vs. Retail Investors: What's the Difference*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/06/institutionalinvestor.asp> [https://web.archive.org/web/20240816083416/https://www.investopedia.com/ask/answers/06/institutionalinvestor.asp] (Aug. 11, 2023); see also Will Kenton, *Operating Expense (OpEx) Definition and Examples*, INVESTOPEDIA, [https://www.investopedia.com/terms/o/operating\\_expense.asp](https://www.investopedia.com/terms/o/operating_expense.asp) [https://perma.cc/LE43-WXQQ] (Feb. 26, 2024).

<sup>68</sup> See *Liu v. SEC*, 591 U.S. 71, 91 (2020) (explaining a general rule under the Restatement (Third) of Restitution and Unjust Enrichment).

<sup>69</sup> See, e.g., Mary Hall, *How Do Fixed and Variable Costs Affect the Marginal Cost of Production?*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/041615/how-do-fixed-and-variable-costs-each-affect-marginal-cost-production.asp> [https://web.archive.org/web/20240816165608/https://www.investopedia.com/ask/answers/041615/how-do-fixed-and-variable-costs-each-affect-marginal-cost-production.asp] (Apr. 8, 2024).

<sup>70</sup> See *Liu*, 591 U.S. at 83, 91, 92.

<sup>71</sup> See *Rubber Co. v. Goodyear*, 76 U.S. 788, 802–03 (1869); Plaintiff Securities & Exchange Commission's Memorandum in Support of its Motion for Disgorgement Against Defendants Liu & Wang at 7, SEC v. Liu, No. SACV 16-00974, 2021 WL 2374248 (C.D. Cal. June 7, 2021) (No. 8:16-cv-00974), 2021 WL 1606540 [hereinafter SEC's Memorandum in Support of its Motion for Disgorgement].

<sup>72</sup> *Kars 4 Kids Inc. v. Am. Can!*, Nos. 3:14-cv-7770, 3:16-cv-4232, 2020 WL 1550804 (D.N.J. Apr. 1, 2020).

<sup>73</sup> *Id.* at \*8.

<sup>74</sup> See SEC v. Thomas James Assocs., Inc., 738 F. Supp. 88, 92 (W.D.N.Y. 1990).

<sup>75</sup> See Alicia Tuovila, *Cost Accounting: Definition and Types with Examples*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/cost-accounting.asp> [https://web.archive.org/web/20240816182605/https://www.investopedia.com/terms/c/cost-accounting.asp] (July 29, 2024).

Financial accounting under a rubric like GAAP does not closely match expenses to revenues. Instead, the focus of GAAP is to ensure that expenses are appropriately placed in the right general category, estimated accurately in terms of amount, and recognized in the right timeframe.<sup>76</sup> GAAP is not focused on categorizing expenses into categories that match directly with sources of revenue.<sup>77</sup> That exercise is more directly the focus of managerial or cost accounting.<sup>78</sup>

*Thomas James Associates, Inc.* and *Litton Industries, Inc. v. Lehman Bros. Kuhn Loeb* are both pre-*Liu* securities law disgorgement cases in which defendants were permitted to deduct reasonable expenses from the disgorgement award.<sup>79</sup> Expenses such as utilities used in fulfilling a government contract obtained through bribery would be deductible because they both offer “value independent of fueling a fraudulent scheme,” and they are costs associated with the revenue subject to disgorgement.

In *SEC v. Mizrahi*,<sup>80</sup> the court similarly permitted the deduction of legitimate expenses from a disgorgement award.<sup>81</sup> Similarly, on remand, the lower court in *Liu* itself permitted the deduction of millions in various fixed and variable expenses.<sup>82</sup>

These individual cases pre-*Liu* (that are consistent with *Liu*) and cases post-*Liu* offer guidance to an expense analysis in disgorgement accounting. But they are limited to the individual facts of each case. For a more general guide, it may prove more useful to focus on the specific damages and equitable remedy treatises that the Supreme Court itself used as a guide in the *Liu* opinion.

<sup>76</sup> *Expense Recognition in the GAAP Hierarchy: Best Practices Unveiled*, FASTERCAPITAL, <https://fastercapital.com/content/Expense-Recognition-in-the-GAAP-Hierarchy--Best-Practices-Unveiled.html> [<https://perma.cc/HFX7-PMFA>] (June 11, 2024). See generally FED ACCT. STANDARDS ADVISORY BD., FASAB HANDBOOK OF FEDERAL ACCOUNTING STANDARDS AND OTHER PRONOUNCEMENTS, AS AMENDED (2023).

<sup>77</sup> See *Expense Recognition in the GAAP Hierarchy: Best Practices Unveiled*, *supra* note 76.

<sup>78</sup> See Alicia Tuovila, *Managerial Accounting Meaning, Pillars, and Types*, INVESTOPEDIA, <https://www.investopedia.com/terms/m/managerialaccounting.asp> [<https://web.archive.org/web/20240816230522/https://www.investopedia.com/terms/m/managerialaccounting.asp>] (June 30, 2024).

<sup>79</sup> See *Thomas James Assocs., Inc.*, 738 F. Supp. at 92; *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb*, 734 F. Supp. 1071, 1077 (S.D.N.Y. 1990).

<sup>80</sup> *SEC v. Mizrahi*, No. CV 19-2284, 2020 WL 6114913 (C.D. Cal. Oct. 5, 2020).

<sup>81</sup> See *id.* at \*2. The court “orders [defendant] to disgorge \$2,408,35,” of ill-gotten gains, made up of \$6,663,535 in gains, reduced by \$4,034,776 that the defendant actually returned himself, and offset by \$220,408 in business expenses “in the form of brokerage commissions and wire transfer fees.” *Id.*

<sup>82</sup> See *SEC v. Liu*, No. SACV 16-00974, 2021 WL 2374248, at \*6–7 (C.D. Cal. June 7, 2021).

*A. Guidance from Secondary Sources of Law, Including Those Cited in the Liu Opinion*

The Restatement (Third) of Restitution and Unjust Enrichment, particularly Section 51 of the Restatement, will likely be the primary source for wading through the remaining interpretive questions about how to calculate disgorgeable net profits post-*Liu*. This is because the Supreme Court cited to the Restatement Section 51 fairly closely in defining *net profits*.<sup>83</sup>

An amicus brief, filed with the Supreme Court in *Liu* by a coalition of law professors interested in the issue of disgorgement jurisprudence,<sup>84</sup> influenced the outcome of the case.<sup>85</sup> Given the amici's influence, it is useful to consider some of its arguments made about disgorgement.

First, the amicus brief noted that much of disgorgement law can be traced back to intellectual property law.<sup>86</sup> The amici professors argued strongly that since 1853 and through the *Kokesh* case that immediately preceded *Liu*, disgorgement remedies have been limited to net profits.<sup>87</sup> Although the amici noted that prior disgorgement rulings found that defendants should be able to deduct expenses from net profits, it argued that defendants should not get a corresponding deduction for income taxes paid because defendants will be able to subtract disgorgement amounts paid against their current year's taxes.<sup>88</sup> This position stands in marked contrast to the perspective offered by Elaine Buckberg and Frederick C. Dunbar, discussed in different sections of this Article,<sup>89</sup> arguing that taxes should be deductible.<sup>90</sup>

The assumption that defendants can deduct their disgorgement amounts against taxes going forward appears to be subject to some uncertainty.<sup>91</sup> After *Kokesh*, it seemed the courts treated

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<sup>83</sup> See *Liu v. SEC*, 591 U.S. 71, 91 (2020).

<sup>84</sup> Brief of Remedies & Restitution Scholars as Amici Curiae in Support of Neither Side at 1, *Liu*, 591 U.S. 71 (No. 18-1501), 2019 WL 7372925, at \*1 [hereinafter Brief of Remedies & Restitution].

<sup>85</sup> See Theresa A. Gabaldon, *Party Games: The Supreme Court's 21st Century Jurisprudence by Telephone*, 75 RUTGERS U. L. REV. 1, 10 (2022).

<sup>86</sup> See Brief of Remedies & Restitution, *supra* note 84, at 2.

<sup>87</sup> *Id.* at 3.

<sup>88</sup> See *id.* at 16.

<sup>89</sup> See discussion *infra* Sections III.B, IV.

<sup>90</sup> See Elaine Buckberg & Frederick C. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, 63 BUS. LAW. 347, 381 (2008).

<sup>91</sup> See Gabaldon, *supra* note 85, at 5–6.

disgorgement as a penalty,<sup>92</sup> in which case the Internal Revenue Service (IRS) would determine that SEC disgorgement payments are not tax deductible.<sup>93</sup> Yet, now that *Liu* seems to treat the payments as non-penalties, the opposite may be true of disgorgement awards.<sup>94</sup>

Also, the amicus brief notes that a net profits “calculation is to be made as a manufacturer calculates the profits of [its] business.”<sup>95</sup> This language suggests other metrics of net profit, such as managerial cost accounting, might be as useful or, at times, even more useful than a GAAP-based formulation.<sup>96</sup>

The 2011 Restatement (Third) of Restitution and Unjust Enrichment provides helpful background to understand some of the open questions left by *Liu*. The Restatement describes the objective of disgorgement as “to eliminate profit from wrongdoing while avoiding, so far as possible, the imposition of a penalty” and to “recognize such credits or deductions . . . consistent with the object of restitution.”<sup>97</sup> It also recognizes there will be situations in which the proper determination of a restitution amount must be based on the present value of property.<sup>98</sup> This implies that, in a subset of situations, it may be more useful to utilize a valuation toolkit with something like a net present value methodology,<sup>99</sup> which is explored below.

The Restatement of Restitution references the use of a market value in cases involving misconduct, while noting that a comparable rental or reasonable royalty method can be relevant in cases involving property.<sup>100</sup> Both methods are frequently utilized in the valuation profession.<sup>101</sup> The Restatement also references that

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<sup>92</sup> See, e.g., *J.P. Morgan Sec., Inc. v. Vigilant Ins. Co.*, 84 N.Y.S.3d 436, 441 (App. Div. 2018) (citing *Kokesh v. SEC*, 581 U.S. 455 (2017)).

<sup>93</sup> See John Marston, Ned Melanson & John Murray, *Are Disgorgement Payments to the SEC Tax-Deductible? U.S. Supreme Court's Decision in Liu v. SEC Complicates the Analysis*, JD SUPRA (July 13, 2020), <https://www.jdsupra.com/legalnews/are-disgorgement-payments-to-the-sec-22250/> [<https://perma.cc/7DWU-WWMV>] (discussing I.R.C. § 162(f)).

<sup>94</sup> See Marston et al., *supra* note 93 (noting that “[i]n light of *Liu*, the IRS may reverse course when finalizing the 162(f) regulations and acknowledge that SEC disgorgement payments are equitable restitution, compensatory in nature, and thus, deductible”).

<sup>95</sup> Brief of Remedies & Restitution, *supra* note 84, at 17.

<sup>96</sup> See *supra* text accompanying notes 76–78.

<sup>97</sup> See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51(4), (5) (AM. L. INST. 2011).

<sup>98</sup> See *id.* § 51 cmt. b.

<sup>99</sup> See Dobromir Dikov, *Using the Net Present Value (NPV) in Financial Analysis*, MAGNIMETRICS, <https://magnimetrics.com/net-present-value-npv-in-financial-analysis/> [<https://perma.cc/H8K4-EHXQ>].

<sup>100</sup> See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. d.

<sup>101</sup> See Pamela Samuelson, John M. Golden & Mark P. Gergen: *Recalibrating the Disgorgement Remedy in Intellectual Property Cases*, 100 B.U. L. REV. 101, 175 (2020).

disgorgements can include illicit profits taking the form of both income and increases in property value.<sup>102</sup> Thus, valuation methods might be useful in some circumstances as a net present value estimate of future net profits.<sup>103</sup> This valuation twist on the net profits calculations of *Liu* is likely rare, focused on situations where a particular piece of property or a parent-owned subsidiary is the focus of the wrongdoing. The more common focus will likely be on a straightforward net profits calculation.

Before getting to the process of determining which expenditures are properly deductible from profits, it is necessary to determine which revenues are themselves tainted by the illicit conduct.<sup>104</sup> This is the essential first step in a disgorgement calculation, as explored above.<sup>105</sup> The Restatement of Restitution describes this as the attribution problem.<sup>106</sup> The analysis in the Restatement<sup>107</sup> fits well with the revenue analysis provided in the second section of this Article<sup>108</sup> and, thus, the Restatement provides more background for understanding step one, explored above.<sup>109</sup>

Three questions that tend to accompany the question of apportionment, according to the Restatement, include: (a) how closely does the chain of causation need to be followed until a unit of revenue is deemed too remote from the wrongdoing; (b) what percentage of profits are connected to the wrongdoing and what percentage of profits are not connected to the wrongdoing; and (c) what credit should be allowed regarding the defendant's own contributions of profits or property in calculating disgorgeable net profits?<sup>110</sup>

It may be tempting to look to GAAP or International Financial Reporting Standards (IFRS) revenue recognition principles to determine whether revenue is recognizable and how to categorize revenue.<sup>111</sup> Indeed, GAAP rules concerning revenue recognition may prove useful. But the difficult questions of attribution are a reminder that the purposes of GAAP and the purposes of disgorgement

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<sup>102</sup> See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. e.

<sup>103</sup> See Dikov, *supra* note 99.

<sup>104</sup> See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. g.

<sup>105</sup> See discussion *supra* Section II.

<sup>106</sup> RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. e.

<sup>107</sup> See *id.*

<sup>108</sup> See discussion *supra* Section II.

<sup>109</sup> See discussion *supra* Section II.

<sup>110</sup> RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. e.

<sup>111</sup> See Alicia Tuovila, *Revenue Recognition: What It Means in Accounting and the 5 Steps*, INVESTOPEDIA, <https://www.investopedia.com/terms/r/revenuerecognition.asp> [https://perma.cc/ZQE8-UX7S] (June 17, 2024); EY, APPLYING IFRS: A CLOSER LOOK AT IFRS 15, THE REVENUE RECOGNITION STANDARD 7–8, 36 (2019).

accounting do not completely overlap. Disgorgement accounting seeks to link a stream of revenues with illicit activity,<sup>112</sup> whereas GAAP is designed to provide investors with information relevant to their investment decisions.<sup>113</sup>

The Restatement of Restitution mentions that one objection to including a particular item of revenue in a disgorgement may be that the item is too remote to be deemed attributable because it either cannot be measured with the required accuracy, or it resulted from legitimate work by the defendant.<sup>114</sup>

One subset of the question of attribution that the Restatement of Restitution and Unjust Enrichment considers is the question of appropriate apportionment.<sup>115</sup> The apportionment question has two distinct features: (a) the percentage of total firm profits connected to the business that can be attributed to the wrongdoing, and (b) the percentage of firm “overhead or other common expenses properly” deducted from those revenues to arrive at disgorgeable net profits.<sup>116</sup>

In a sense, the attribution problems add a dimension to each of the two elements of the *Liu* disgorgement accounting analysis.<sup>117</sup> How should revenues that have mixed sources between different parties or that have a mixed character of illicit/legitimate be apportioned? How can expenses that might be shared between different entities or that have a mixed character of partly deductible and partly non-deductible be apportioned for the second step of a *Liu* disgorgement accounting?

The Restatement of Restitution describes how apportionment leads to a situation where “the court confronts a further problem of apportionment that ordinary accounting practice has no call to address.”<sup>118</sup> This gets into difficult questions to determine what percentage of a defendant’s revenue would still have happened and which percentage would not have been available absent the wrong.<sup>119</sup>

The Restatement of Restitution notes that

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<sup>112</sup> See Div. of Enf’t, Sec. & Exch. Comm’n, Audit 311, Disgorgements 2 (2001).

<sup>113</sup> Jason Fernando, *Generally Accepted Accounting Principles: Definition and Rules*, INVESTOPEDIA, <https://www.investopedia.com/terms/g/gaap.asp> [https://perma.cc/M2YS-X4FE] (June 27, 2024).

<sup>114</sup> RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. f.

<sup>115</sup> See *id.* cmt. g.

<sup>116</sup> *Id.*

<sup>117</sup> See discussion *supra* Sections II, III.

<sup>118</sup> RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. g.

<sup>119</sup> See *id.*

the defendant is entitled to a deduction for all marginal costs incurred in producing the revenues that are subject to disgorgement. . . . [T]he defendant will not be allowed to deduct expenses (such as ordinary overhead) that would have been incurred in any event, if the result would be that defendant's wrongful activities—by defraying a portion of overall expenses—yield an increased profit from defendant's operations as a whole.<sup>120</sup>

Thus, there is language in the treatise suggesting that both overhead expenses can, at times, be properly deducted to obtain disgorgeable net profits, but at other times that they cannot be deducted. This suggests that a careful distinction should be included in the analysis between those overhead expenses that can be linked to the production of the tainted revenue, and those overhead expenses that cannot be allocated.

A carefully and credibly constructed activity-based costing framework can help to resolve those issues,<sup>121</sup> particularly if that framework closely tracks the firm's own internal activity-based cost models used before the enforcement action, or at least tracks activity-based costing models used by other firms in related industries. This would leverage tools used by managers in cost accounting to determine operations performance,<sup>122</sup> a different method of accounting from that utilized in GAAP financial accounting.<sup>123</sup>

The Restatement of Restitution notes that “[t]he defendant will not be allowed a credit for the direct expenses of an attempt to defraud the claimant.”<sup>124</sup> Thus, “dirty” expenses that were solely or primarily undertaken to further illicit conduct will not be permitted as part of the deduction to arrive at illicit profits.

The Restatement of Restitution mentions that tax payments are not typically allowed to be deducted to determine net profits when the disgorgement payment itself is allowed to be deducted from the firm's taxes because doing so might otherwise result in a windfall to the wrongdoer.<sup>125</sup> This, again, is in contrast to Buckberg and

<sup>120</sup> *Id.* cmt. h.

<sup>121</sup> See Will Kenton, *Activity-Based Costing (ABC): Method and Advantages Defined with Example*, INVESTOPEDIA, <https://www.investopedia.com/terms/a/abc.asp> [<https://perma.cc/GW9Y-K4LF>] (Aug. 7, 2024).

<sup>122</sup> See *id.*

<sup>123</sup> See Tuovila, *supra* note 75.

<sup>124</sup> RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 51 cmt. h.

<sup>125</sup> See *id.* illus. 23.

Dunbar's analysis<sup>126</sup> and may result from the difference between individual defendants (who cannot deduct expenses from trading profits on taxes) and corporate entities (who typically can do so),<sup>127</sup> and may further turn on the question of whether SEC disgorgement payments are in fact subsequently tax deductible for corporate defendants per IRS guidance.<sup>128</sup>

The Restatement of Restitution cites case law to support that, following the principle that a mere "reasonable approximation" of disgorgeable profits is required, when a range of estimates of disgorgeable net profits is available, the upper end of the range is to be selected so that the uncertainty falls against the wrongdoer.<sup>129</sup> This suggests that if a methodology to determine net profits uses a mixture of multiple methods, the highest estimate may end up being selected.

If, for example, a disgorgement calculation is conducted using a mixture of different valuation methods, as is common in valuation practice,<sup>130</sup> the highest estimate may end up being selected despite the industry practice of using some independent valuation models as a mere reasonableness check for the valuation professional's final estimate.<sup>131</sup> The common valuation practice of developing multiple valuation models and assigning relative weights to each to then arrive at a weighted average valuation<sup>132</sup> may not be feasible in this context either, as the SEC or court may simply utilize the highest estimate in the group.

Another way in which market appraisals may be utilized in disgorgement calculations, suggested by the Restatement of Restitution,<sup>133</sup> would be to utilize a market appraisal of the value of

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<sup>126</sup> See Buckberg & Dunbar, *supra* note 90, at 381.

<sup>127</sup> See Toby Mathis, *How to Qualify for Trader Tax Status*, ANDERSON ADVISORS, <https://andersonadvisors.com/trader-tax-status/> [<https://perma.cc/5QCV-PVJB>] (Oct. 5, 2021); see also *Credits and Deductions for Individuals*, IRS, <https://www.irs.gov/credits-and-deductions-for-individuals> [<https://perma.cc/B477-2VE2>].

<sup>128</sup> See Marston et al., *supra* note 93.

<sup>129</sup> See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 51 cmt. i (quoting *Gratz v. Claughton*, 187 F.2d 46 (2d Cir. 1951)).

<sup>130</sup> See Kison Patel, *9 Business Valuation Methods: What's Your Company's Value?*, DEALROOM, <https://dealroom.net/faq/valuation-methods> [<https://perma.cc/R4YW-GP4L>] (May 7, 2024).

<sup>131</sup> See, e.g., *2.11 Reasonableness Testing in Valuation Reports*, MAARSCHALK VALUATIONS INC., <https://valuationsandplanning.com/understanding-business-valuators-reports/5-15-reasonableness-testing-in-valuation-reports/> [<https://perma.cc/RFC5-P23X>].

<sup>132</sup> See Mark S. Gottlieb, *Weighting Different Methods to Determine Value*, MSG ACCTS., CONSULTANTS & BUS. VALUATORS (Sept. 2016), <https://www.msgcpa.com/forensicperspectives/weighting-different-methods-determine-value/> [<https://perma.cc/PC2L-BAF3>].

<sup>133</sup> See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 51 illus. 22.

the services provided by culpable executives as a check on whether they are paying themselves excessive compensation that is not legitimately deductible in a disgorgement calculation.

The Restatement of Restitution mentions the question of set-off and whether a defendant could set off multiple lines of business revenue or multiple series of trades, for which some may constitute a net profit, and some may constitute a net loss.<sup>134</sup> Are they all to be considered netted together for the net profit or loss for the group of illicit activity as a whole, or must each distinct item be considered separately with no right of set-off? In other words, are net loss business lines or trades ignored in the wider disgorgement calculation?

The Restatement doesn't resolve this question, citing some case law suggesting set-off is not allowed where the individual transactions are distinguishable but also noting that the degree of set-off permitted will depend on the degree of culpability of the defendant.<sup>135</sup> In the event the right of set-off is not permitted, then defendants may be able to argue post-*Liu* that a penalty is being enforced that is prohibited by *Liu*.<sup>136</sup>

One treatise on contracts notes that the disgorgement measure is intended to match the damages of the injured party.<sup>137</sup> One treatise on damages suggests that

In deducting expenses, courts generally consider overhead expenses in addition to direct costs, as long as there is (a) a “sufficient nexus” between the category of expenses and the production or sale of the infringing item, and (b) a “fair, accurate, and practical method for allocating the implicated overhead to the infringer” . . . [where] calculating and apportioning a defendant's profits typically requires expert analysis.<sup>138</sup>

A robust activity-based cost framework<sup>139</sup> may be just the ticket for meeting the requirement for a “fair, accurate, and practical method”

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<sup>134</sup> See *id.* § 51 reporter's note j.

<sup>135</sup> See *id.* (citing *State v. Morgan Stanley & Co.*, 459 S.E.2d 906 (W. Va. 1995)).

<sup>136</sup> See Marston et al., *supra* note 93.

<sup>137</sup> See MELVIN A. EISENBERG, *The Disgorgement Interest in Contract Law*, in FOUNDATIONAL PRINCIPLES OF CONTRACT LAW: THE OXFORD COMMENTARIES ON AMERICAN LAW 335, 335 (Stephen M. Sheppard ed., 2018).

<sup>138</sup> 11 JAY COHEN & LYNN B. BAYARD, BUSINESS AND COMMERCIAL LITIGATION IN FEDERAL COURTS §118:85 (Robert L. Haig ed., 5th ed. 2021).

<sup>139</sup> See Kenton, *supra* note 121.

for finding a “sufficient nexus” between the illicit revenue and overhead expenses.

This review of the perspectives of leading treatises is not the last word on the open questions remaining post-*Liu*. The principles, however, contained therein are likely the best guide for navigating those questions. To the extent that forensic accountants<sup>140</sup> must make interpretive judgment calls in conducting a disgorgement accounting analysis, they would do well to cite arguments for why their judgments are consistent with principles contained in these treatises and the case law that has such a close connection with the *Liu* case.

### *B. Standard Expenses Under GAAP*

The *Liu* case does not hold that disgorgement calculations are limited to GAAP accounting. Net profits calculations are calculated in different ways under different methodologies for different purposes.<sup>141</sup> Net profits, according to GAAP, may be different from income tax accounting, IFRS accounting, managerial or cost accounting, and regulatory accounting.<sup>142</sup> Each of these methods may compute income in a different way because of a different group of users for which the financial data is intended.<sup>143</sup>

Buckberg and Dunbar suggest that it would not be appropriate to calculate disgorgement amounts on a pre-tax basis, and that it is instead more appropriate to calculate on an after-tax basis.<sup>144</sup> This runs contrary to treatises in the prior section that suggest the opposite is true,<sup>145</sup> and if equitable disgorgement remedies are tax deductible,<sup>146</sup> the post-tax method would result in a windfall to the defendant.<sup>147</sup>

Buckberg and Dunbar argue in favor of using after-tax numbers and suggest that, at a minimum, in order to determine prejudgment

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<sup>140</sup> See Adam Hayes, *Forensic Accounting: What It Is, How It's Used*, INVESTOPEDIA, <https://www.investopedia.com/terms/f/forensicaccounting.asp> [https://perma.cc/UAB3-BNRF] (June 13, 2024).

<sup>141</sup> See *How to Calculate Net Profit*, INDEED, <https://www.indeed.com/career-advice/career-development/how-to-calculate-net-profit> [https://web.archive.org/web/20240818145525/https://www.indeed.com/career-advice/career-development/how-to-calculate-net-profit] (July 2, 2024).

<sup>142</sup> See discussion *infra* Sections III.C, III.D.

<sup>143</sup> See discussion *infra* Sections III.C, III.D.

<sup>144</sup> See Buckberg & Dunbar, *supra* note 90, at 381.

<sup>145</sup> See *supra* text accompanying note 120.

<sup>146</sup> See *supra* text accompanying note 128.

<sup>147</sup> See Buckberg & Dunbar, *supra* note 90, at 381.

interest, the after-tax numbers need to be computed.<sup>148</sup> The logic of this approach depends on whether the amounts at issue are relevant to taxation. Individuals will pay taxes on net gains, but for purposes of calculating federal taxable income, individuals will not typically be able to deduct their trading expenses from their taxes.<sup>149</sup> Businesses, on the other hand, are able to deduct their initial expenses on their federal tax return and may be able to deduct subsequent disgorgement amounts for federal tax purposes.<sup>150</sup>

Disgorgements are a penalty for purposes of *Kokesh* but not a penalty for purposes of *Liu*, creating some uncertainty post-*Liu* and post-*Kokesh* over whether these initial and subsequent expenses are deductible in the case of SEC disgorgements.<sup>151</sup> The difference may fall with respect to whether the defendant is a business that can deduct disgorgement amounts or whether the defendant is an individual who cannot subsequently deduct the cost of disgorgement awards.

There are a number of open questions even in a standard application of GAAP to a disgorgement calculation. Rather than answer all of them, this subsection will endeavor to identify some of the more difficult open questions in a GAAP-based net profits disgorgement calculation that may need to be ultimately resolved as part of a fact-specific inquiry involving issues of a particular defendant.

To the extent that a company experiences changes in equity because of treasury stock purchases and sales, would any increase in Additional Paid-In Capital (APIC)<sup>152</sup> resulting from treasury stock acquisitions be considered disgorgeable? How is disgorgement measured when a company is sued for insider trading in its own stock?

Technically, net profits are zeroed out every year and put into retained earnings.<sup>153</sup> If all net profits from illegal activity (and/or all

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<sup>148</sup> See *id.*

<sup>149</sup> See Jason Fernando, *Capital Gains Tax: What It Is, How It Works, and Current Rates*, INVESTOPEDIA, [https://www.investopedia.com/terms/c/capital\\_gains\\_tax.asp](https://www.investopedia.com/terms/c/capital_gains_tax.asp) [https://perma.cc/6YYW-95S5] (June 18, 2024); *Credits and Deductions for Individuals*, *supra* note 127.

<sup>150</sup> See Mathis, *supra* note 127; Marston et al., *supra* note 93.

<sup>151</sup> Marston et al., *supra* note 93.

<sup>152</sup> See generally Will Kenton, *Additional Paid-In Capital: What It Is, Formula, and Examples*, INVESTOPEDIA, <https://www.investopedia.com/terms/a/additionalpaidincapital.asp> [https://perma.cc/N9LR-PFLK] (June 8, 2024).

<sup>153</sup> See CHRISTINE JONICK, *PRINCIPLES OF FINANCIAL ACCOUNTING* 15, 35 (2017) (“The income statement reports net income for one period, such as . . . a year. . . . The net income amount that appears on the retained earnings statement comes from the income statement . . .”).

net profits generally) have been transferred to retained earnings, then have been distributed as dividends,<sup>154</sup> are there net profits left to be disgorged? How would you allocate if not all retained earnings are distributed every year? Or, do the recent court holdings that there is no tracing requirement<sup>155</sup> mean that retained earnings do not need to be apportioned, even though much of the earnings are a direct transfer from an income statement account?

This goes to the fact that the courts have said there is no tracing requirement, which may seem like an artificial distinction. If, indeed, the net profits from fraud have been distributed, then any amount being disgorged is not truly net profit from fraud. It seems inconsistent that cash proceeds from fraud, transferred to retained earnings and distributed as a dividend, would not be deducted from the disgorgement amount, while cash proceeds expended for the business are deducted from a disgorgement amount, but that is the law at present. Multiple court cases have ruled that there is no requirement to trace the net proceeds to a specific allocation of money.<sup>156</sup>

The initial cases post-*Liu* holding that there is no direct tracing requirement<sup>157</sup> would seem to suggest that subsequent dividends of illicit funds would be irrelevant. This holding leads to the odd trade-off that retained earnings kept and used in subsequent periods as expenses would be deducted from a disgorgement calculation, while retained earnings distributed as dividends would not affect a disgorgement calculation.

Further, in the event that a company and an individual are jointly liable, then dividends of illicit funds will be important—not as a function of tracing, per se, but as a function of an apportionment calculation to divide the illicit revenues between culpable parties<sup>158</sup> without double counting them.

Another open question will be whether GAAP policies on consolidation, control treatment, or fair value<sup>159</sup> through net income similarly apply for this purpose when a company is 20% or 50%-plus owned.

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<sup>154</sup> *Id.* at 28.

<sup>155</sup> See *supra* text accompanying notes 38, 44.

<sup>156</sup> See, e.g., SEC v. Camarco, No. 19-1486, 2021 WL 5985058, at \*17 (10th Cir. Dec. 16, 2021); SEC v. de Maison, No. 18-2564, 2021 WL 5936385, at \*2 (2d Cir. Dec. 16, 2021) (quoting SEC v. Contorinis, 743 F.3d 296 (2d Cir. 2014)); SEC v. Hallam, 42 F.4th 316, 336 (5th Cir. 2022).

<sup>157</sup> See cases cited *supra* note 156; see also *Liu v. SEC*, 591 U.S. 71, 1947 (2020)).

<sup>158</sup> See *supra* text accompanying note 49.

<sup>159</sup> See generally Kiley Arnold, *Investment Accounting Methods Under US GAAP Explained*, FINQUERY (Nov. 12, 2021), <https://finquery.com/blog/investment-accounting-methods-us-gaap/> [<https://perma.cc/5GGS-L8JE>].

The issues presented in the SEC context will, to some extent, apply to the Department of Justice's (DOJ) coordinated review and settlement of joint SEC and DOJ investigations,<sup>160</sup> even though the doctrinal concepts may not overlap completely. For example, how will the SEC and DOJ FCPA policies on when to hold parent companies liable for acquired firms<sup>161</sup> apply? How will they adapt to determine whether to rely on GAAP consolidated accounting methods for subsidiaries or to utilize a valuation methodology instead<sup>162</sup> to determine increases in value to the subsidiary resulting from harmful conduct? The DOJ's and SEC's resource guide may offer some indications for how FCPA cases at DOJ might impact the SEC side, and SEC guidance on FCPA matters may provide further guidance to issues at the intersection of the law and accounting issues.<sup>163</sup>

If, for example, the subsidiary's treatment is Fair Value Through Net Income (FVTNI) or consolidated control treatment,<sup>164</sup> then a change in valuation of the subsidiary to measure the disgorgeable amount would not be appropriate unless you back out the revenue and expenses that are consolidated either partly or wholly into the owner.

Will inter-company sales, exchanges of property, or investments in bonds, and the like be consolidated in the same method they are for GAAP? Will inter-firm transfers be accounted for using concepts from IRS transfer pricing rules<sup>165</sup> instead? Will a similar specialized expert transfer pricing analysis utilized in proceedings with the IRS<sup>166</sup> also be used to justify expert determinations about how to

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<sup>160</sup> See generally Michael S. Schachter & Anna M. Hershenberg, *Can SEC/DOJ Cooperation Ever Cross the Line?: What Is Left of U.S. v. Scrushy in the Wake of the Ninth Circuit's Reversal of U.S. v. Stringer*, 40 SEC. REGUL. & L. REP. 672, 672 (2008); LATHAM & WATKINS LLP, SEC INVESTIGATIONS: A GUIDE FOR PUBLIC COMPANY DIRECTORS, OFFICERS, AND IN-HOUSE COUNSEL 15 (2d ed. 2020).

<sup>161</sup> See generally CRIM. DIV., U.S. DEP'T JUST & ENF'T DIV., SEC. & EXCH. COMM'N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT 29–32 (2d ed. 2020) [hereinafter DOJ & SEC RESOURCE GUIDE].

<sup>162</sup> See generally Patel, *supra* note 130.

<sup>163</sup> See DOJ & SEC RESOURCE GUIDE, *supra* note 161, at 50–56; *SEC Enforcement Actions: FCPA Cases*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/enforce/sec-enforcement-actions-fcpa-cases> [<https://web.archive.org/web/20240820015907/https://www.sec.gov/enforce/sec-enforcement-actions-fcpa-cases>] (Apr. 22, 2024).

<sup>164</sup> See FASB Proposes Improvements to Recognition and Measurement of Financial Assets and Liabilities, FASB (Feb. 14, 2013) [https://www.fasb.org/page/getarticle?uid=fasb\\_NewsRelease02-14-13Body\\_0228221200](https://www.fasb.org/page/getarticle?uid=fasb_NewsRelease02-14-13Body_0228221200) [<https://perma.cc/28FL-GKLA>]; Arnold, *supra* note 159.

<sup>165</sup> See generally I.R.C. § 482.

<sup>166</sup> See generally INTERNAL REVENUE SERV., DEPT OF TREASURY, NO. 5300, TRANSFER PRICING EXAMINATION PROCESS (2020).

treat inter-company transfers for purposes of a disgorgement accounting?

Will a method for goodwill impairment of subsidiaries be considered similarly to GAAP?<sup>167</sup> Particularly for subsidiaries involved in the wrongdoing? If the subsidiary has engaged in illicit bribery, but that line of business has been sufficiently unprofitable so that the parent firm has impaired goodwill estimates for that acquired subsidiary, will a net profit disgorgement be inappropriate because of the impairment in the subsidiary's value despite some net profits from the illicit revue during particular years?

Will Asset Retirement Obligation (ARO) amortization methods from GAAP<sup>168</sup> be utilized when there are ARO-related expenses connected to a violation subject to disgorgement? Will these ARO methods be especially applicable if a case involves allegations of disclosure fraud about the value or risk associated with those AROs?

What if there is a future loss contingency<sup>169</sup> associated with the wrongful activity? Would similar categories utilized in GAAP accounting of remote, reasonably possible, and likely<sup>170</sup> be utilized for risk weights?

Loss contingencies resulting from expected disgorgement awards accounted for in advance of an actual settlement or court award present an odd feedback loop. Technically, the net profits from the illicit activity may already be expensed in prior reporting periods<sup>171</sup> in expectation of the later disgorgement. That would mean, however, that, in calculating the actual disgorgement award, the prior loss contingency expense should be subtracted because it has already been expensed, which may bring the disgorgement to zero. Yet, unless there is an actual disgorgement payment, the original loss contingency would have to be reversed.<sup>172</sup>

Because of the feedback loop created by deducting reported loss contingencies from disgorgement awards, the SEC and courts will likely try to ignore prior expensing of loss contingencies in a

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<sup>167</sup> See generally Alicia Tuovila, *Goodwill Impairment: Definition, Examples, Standards, and Tests*, Investopedia, <https://www.investopedia.com/terms/g/goodwill-impairment.asp> [https://perma.cc/4MQQ-CE53] (Feb. 23, 2021).

<sup>168</sup> See generally EY, FINANCIAL REPORTING DEVELOPMENTS, A COMPREHENSIVE GUIDE: ASSET RETIREMENT OBLIGATIONS 1 (2023).

<sup>169</sup> See generally Eugene Goldman & Scott Taub, *Capital Markets, Professional Perspective—Assessing Loss Contingencies from Litigation and Regulatory Exposures*, BLOOMBERG L. (April 2021), <https://www.bloomberglaw.com/external/document/X8HJMK1O000000/capital-markets-professional-perspective-assessing-loss-continge> [https://perma.cc/TT4D-5VXD].

<sup>170</sup> See generally *id.*

<sup>171</sup> See *id.*

<sup>172</sup> See *id.*

disgorgement calculation. That decision, however, is not quite consistent with a pure GAAP estimate of net profits.<sup>173</sup> Nevertheless, pre-investigation legal expenses would seem to be appropriately deductible.<sup>174</sup>

To what extent will items be treated differently between GAAP rules and IFRS, such as new lease classification rules,<sup>175</sup> and which rules should internationally operating firms use? If an expense is effectively hedged,<sup>176</sup> is it not included for purposes of these calculations? Are the foreign currency translation methods used under GAAP<sup>177</sup> also used for disgorgement calculations? Particularly where the wrongdoing occurred within a foreign subsidiary whose earnings are in a foreign currency?

It is notable that the tax treatment for excess of percentage depletion over cost depletion has different methods for Tax Basis versus GAAP.<sup>178</sup> How is that considered here, particularly for extractive resource companies that use those depletion methodologies and that are often featured in FCPA disgorgements?<sup>179</sup>

If you obtained an increase in value from a securities law violation for a component of a business, such as an FCPA violation, but you have since taken an impairment loss on that component, for example, because of discontinued business operations,<sup>180</sup> is that impairment loss considered a deductible expense for purposes of a disgorgement net profit calculation?

What if the firm has had an estimate change as a result of:

<sup>173</sup> See Dominic Diongson, *What Is Net Income? Definition, Calculation & Example*, STREET, <https://www.thestreet.com/dictionary/net-income-ni> [https://web.archive.org/web/20240820041828/https://www.thestreet.com/dictionary/net-income-ni] (Oct. 5, 2022, 9:09 AM).

<sup>174</sup> See *Liu v. SEC*, 591 U.S. 71, 91–92 (2020) (quoting *Tilgham v. Proctor*, 125 U.S. 136 (1888)).

<sup>175</sup> See generally PwC, IFRS and US GAAP: Similarities and Differences 14-11–14-12 (2024).

<sup>176</sup> See generally *Hedge Definition and How It Works in Investing*, INVESTOPEDIA, <https://www.investopedia.com/terms/h/hedge.asp> [https://web.archive.org/web/20240820053903/https://www.investopedia.com/terms/h/hedge.asp] (June 23, 2024).

<sup>177</sup> See generally Christine Leese, *Overview of Foreign Currency Translation Under ASC 830*, GAAP DYNAMICS (Aug. 2, 2016), <https://www.gaapdynamics.com/insights/blog/2016/08/02/dive-into-asc-topic-830-%28fas-52%29-to-better-understand-foreign-currency-translation/> [https://perma.cc/F6LC-7EW6].

<sup>178</sup> See *How to Calculate Depletion Expense*, THOMSON REUTERS (Oct. 31, 2023), <https://tax.thomsonreuters.com/blog/how-to-calculate-depletion-expense/> [https://perma.cc/M2ZB-NZSL]; *GAAP (U.S.) vs. Tax Basis Financial Reporting*, GEFFEN MESHER (Apr. 15, 2019), <https://gmco.com/gaap-u-s-vs-tax-basis-financial-reporting/> [https://perma.cc/V45L-423E] (explaining the difference between GAAP accounting and other tax bases).

<sup>179</sup> See generally *How to Calculate Depletion Expense*, *supra* note 178; *SEC Enforcement Actions: FCPA Cases*, *supra* note 163.

<sup>180</sup> See generally PwC, *supra* note 47, at 8-29, 27-10.

- A change in the life of fixed assets;<sup>181</sup>
- Taking stock of obsolete inventory;<sup>182</sup>
- Material, non-recurring IRS adjustments;<sup>183</sup>
- Settlement of litigation; or
- Changes in accounting principles inseparable from a change in estimate?<sup>184</sup>

For all of the above, GAAP says you do not restate prior years.<sup>185</sup> But, does the net profit determination for purposes of disgorgement rules follow GAAP, or would a defendant be permitted to restate prior years for purposes of a net profit disgorgement calculation? Otherwise, the disgorgement measure would seem to become a form of improper penalty.

Variations in accounting principle or a change due to error automatically includes a change to prior periods or to retained earnings for GAAP purposes.<sup>186</sup> Is this the same approach a net profits determination for GAAP would follow?

How is Other Comprehensive Income (OCI)<sup>187</sup> treated? One common OCI gain/loss is foreign currency hedges for investments in foreign companies,<sup>188</sup> which could have significance for FCPA cases. The same issue arises for cash flow hedges and for instrument-specific credit risk changes for liabilities for which the fair value option is elected.<sup>189</sup> The same issue is also apparent for pension benefit adjustments.<sup>190</sup> How will these be accounted for in a disgorgement accounting?

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<sup>181</sup> See generally PwC, Property, Plant, Equipment and Other Assets 4-6–4-7 (2024).

<sup>182</sup> See generally Alicia Tuovila, *What Is Obsolete Inventory, and How Do You Account for It?*, INVESTOPEDIA <https://www.investopedia.com/terms/o/obsoleteinventory.asp> [https://web.archive.org/web/20240820065200/https://www.investopedia.com/terms/o/obsoleteinventory.asp] (May 31, 2024).

<sup>183</sup> See Jason Fernando, *What is Adjusted Gross Income (AGI)?*, INVESTOPEDIA <https://www.investopedia.com/terms/a/agi.asp> [https://perma.cc/LM5G-T9L4] (June 8, 2024).

<sup>184</sup> See generally PwC, *supra* note 47, at 30-9–30-10.

<sup>185</sup> See generally PwC, *supra* note 47, at 2-3.

<sup>186</sup> See EY, FINANCIAL REPORTING DEVELOPMENTS, A COMPREHENSIVE GUIDE: ACCOUNTING CHANGES AND ERROR CORRECTIONS 2 (2023).

<sup>187</sup> See generally Andrew Bloomenthal, *Other Comprehensive Income: What It Mean, with Examples*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/071415/what-are-some-examples-items-count-comprehensive-income.asp> [https://perma.cc/B9YJ-KK6E] (July 22, 2024).

<sup>188</sup> See *id.*

<sup>189</sup> See generally PwC, DERIVATIVES AND HEDGING 5-3 (2024); PwC, FAIR VALUE MEASUREMENTS 5-9–5-10 (2022).

<sup>190</sup> See, e.g., generally Cost of Living Adjustment, <https://www.osc.ny.gov/retirement/retirees/cost-living-adjustment> [https://perma.cc/7RKQ-66JR] (last updated July 2024).

What if an entity has purchased shares based on inside information, has not sold the shares, and has booked an unrealized loss (but not a net loss) on the shares using a fair value estimate? Does that loss subtract from the net-profits calculation?

If a subsidiary's fair value change is utilized to determine net profit, does that valuation approach need to follow GAAP's Accounting Standards Update (ASU) regarding fair value?<sup>191</sup>

Should a company's prior inventory write-down, which cannot be reversed under GAAP,<sup>192</sup> be reversed under a disgorgement calculation? What about the same question for a write-down or an impairment to Property, Plant, and Equipment (PP&E)?<sup>193</sup>

Should the disgorgement calculation use Last-In, First Out (LIFO) or First-In, First Out (FIFO)<sup>194</sup> for these purposes? There is a clear impact on net profit during the typical environment of rising prices.<sup>195</sup> Are you required to use the same method for disgorgement that you use for tax and financial accounting?

If you are estimating a change in the value of a subsidiary, what adjustments do you make to the value? What questions could arise about whether to capitalize versus expense determinations in PP&E? Should one utilize the same depletion methods used under GAAP for this purpose? Should the same percentage depletion methods used for tax be used in this context? Would this be particularly true for extractive industry FCPA cases?

GAAP requires expensing of research and development (R&D) and no capitalization in most cases.<sup>196</sup> Is this approach optimal for this purpose, or would it be better to instead capitalize R&D and reverse the expense, particularly if tax law or IFRS uses that approach? Also, there is special treatment for R&D developed for a client of computer

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<sup>191</sup> See generally FIN. ACCT. STANDARDS BD., NO. 2022-03, ACCOUNTING STANDARDS UPDATE: FAIR VALUE MEASUREMENT (Topic 820) (2022).

<sup>192</sup> Sean Ross, *How Does Inventory Accounting Differ Between GAAP and IFRS?*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/052015/how-does-inventory-accounting-differ-between-gaap-and-ifrs.asp> [<https://perma.cc/9WCY-HZ9H>] (June 30, 2024).

<sup>193</sup> See generally Chris B. Murphy, *What Is Property, Plant, and Equipment (PP&E)?*, INVESTOPEDIA, <https://www.investopedia.com/terms/p/ppe.asp> [<https://perma.cc/4TBR-ANM2>] (June 7, 2024).

<sup>194</sup> See generally Carla Tardi, *FIFO vs. LIFO Inventory Valuation*, INVESTOPEDIA, <https://www.investopedia.com/articles/02/060502.asp> [<https://perma.cc/G6N5-K6AR>] (June 3, 2024).

<sup>195</sup> See Roman Basi, *Weighing the Impact of Inflation on Profits*, FLOOR COVERING NEWS (May 1, 2023), <https://www.fcnews.net/2023/05/weighing-the-impact-of-inflation-on-profits/> [<https://perma.cc/S2MM-JP4D>].

<sup>196</sup> See Kevin Bogle, PK Kalavacherla, Valerie Boissou & Holger Erchinger, *IFRS vs. US GAAP: R&D Costs*, KPMG, <https://kpmg.com/us/en/articles/2023/ifrs-vs-us-gaap-rd-costs.html> [<https://perma.cc/5N5N-YCVX>].

software where it can be capitalized at the point of commercial viability.<sup>197</sup> Does that continue in net profit determination for this purpose?

What about held-for-trading securities for which unrealized changes in fair market value are booked to earnings?<sup>198</sup> What about available-for-sale securities for which changes in fair market value are booked to OCI,<sup>199</sup> particularly if insider trading or other illicit activity occurs in connection with ownership in these securities?

GAAP procedures may simply relate to purposes distinct from those used for this purpose. If you are presenting an old set of financial statements, maybe the special rules for the re-issuance of GAAP amounts<sup>200</sup> may give some guidance where there are timing issues.

### *C. Alternative Methods: Managerial Cost Accounting*

The Supreme Court in *Liu* referenced the 1869 Supreme Court opinion *Rubber Co. v. Goodyear* for the principle that disgorgement should be limited to net profits.<sup>201</sup> A section of that case is worth quoting in full since it describes a methodology consistent with managerial cost accounting:

“The profits made in violation of the rights of the complainants” in this class of cases, within the meaning of the law, are to be computed and ascertained by finding the difference between cost and yield. In estimating the cost, the elements of price of materials, interest, expenses of manufacture and sale, and other necessary expenditures, if there be any, and bad debts, are to be taken into the account, and usually nothing else. The calculation is to be made as a manufacturer calculates the profits of [their] business. “Profit” is the gain made upon any business or investment, when both the receipts and payments are taken into the account. The rule is founded in reason and justice. It

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<sup>197</sup> See PWC, *supra* note 47, at 8-24–8-25.

<sup>198</sup> See generally James Chen, *What Is Held-for-Trading Security? Role of Fair Value Adjustment*, INVESTOPEDIA, <https://www.investopedia.com/terms/h/held-for-trading-security.asp> [https://perma.cc/RP93-N8QF] (Dec. 12, 2020).

<sup>199</sup> See generally Alicia Tuovila, *Available-for-Sale Securities: Definition, vs. Held-for-Trading*, INVESTOPEDIA, <https://www.investopedia.com/terms/a/available-for-sale-security.asp> [https://perma.cc/TS2A-C6WL] (June 5, 2024).

<sup>200</sup> See generally PWC, *supra* note 47, at 28-14.

<sup>201</sup> See *Liu v. SEC*, 591 U.S. 71, 83 (2020) (quoting *Rubber Co. v. Goodyear*, 76 U.S. 788 (1869)).

compensates one party and punishes the other. It makes the wrong-doer liable for actual, not possible, gains.<sup>202</sup>

This excerpt references not only marginal costs but fixed overhead costs such as interest on loans. Thus, offhand references made to marginal expenses in the *Liu* opinion<sup>203</sup> should not be taken as a limitation on the proper deduction of fixed costs when a reasonable allocation methodology<sup>204</sup> is utilized. The Supreme Court in *Liu* itself noted that, in that case, the defendant had undertaken some potentially legitimate expenses, including lease payments and fixed equipment.<sup>205</sup>

Upon remand in the *Liu* case, the SEC objected to a number of Liu's claimed expenses on the grounds that they represented sums not reflected in audited financial statements or even in financial statements reviewed or compiled by Certified Public Accountants (CPAs).<sup>206</sup> However, the SEC's motion in the remanded *Liu* case recognized a number of legitimate expenses, including "construction, rent, equipment, and other operating expenses (tax payments, insurance costs, travel, consulting fees, permit, and license fees, among others) reflected in the corporate defendants' bank records in the time period for which that source data is available."<sup>207</sup> This list of expenses indicates acceptance by the SEC that general overhead<sup>208</sup> can be legitimately deducted to arrive at a net profits calculation.

Pre-*Liu*, some cases allowed general business expenses deductions but disallowed the deduction of allocated overhead expenses.<sup>209</sup> Yet, the Supreme Court's reliance in *Goodyear* on an old analysis that

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<sup>202</sup> *Goodyear*, 76 U.S. at 804; see Tuovila, *supra* note 78.

<sup>203</sup> See *Liu*, 591 U.S. at 91.

<sup>204</sup> See generally *Cost Allocation Methodology Best Practices*, UCSF: CONTROLLER'S OFF., <https://controller.ucsf.edu/reference/contracts-grants-accounting/cost-allocation-methodology-best-practices> [<https://perma.cc/G43T-H3QU>].

<sup>205</sup> *Liu*, 591 U.S. at 92.

<sup>206</sup> See SEC's Memorandum in Support of its Motion for Disgorgement, *supra* note 71, at 6; see generally Adam Hayes, *Certified Public Accountant: What the CPA Credential Means*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/cpa.asp> [<https://perma.cc/5TPQ-F5VL>] (Apr. 7, 2024).

<sup>207</sup> SEC's Memorandum in Support of its Motion for Disgorgement, *supra* note 71, at 7–8.

<sup>208</sup> See generally Alicia Tuovila, *Overhead: What It Means in Business, Major Types, and Examples*, INVESTOPEDIA, <https://www.investopedia.com/terms/o/overhead.asp> [<https://perma.cc/LK6E-EWAN>] (Feb. 11, 2024).

<sup>209</sup> See Kirk, *supra* note 54, at 137 & n.19, 140 & n.38 (first citing SEC v. Berlacher, No. 07-3800, 2010 WL 3566790 (E.D. Pa. Sept. 13, 2010); SEC v. Universal Express, Inc., 646 F. Supp. 2d 552 (S.D.N.Y. 2009); SEC v. McCaskey, No. 98 Civ. 6153, 2002 WL 850001 (S.D.N.Y. Mar. 26, 2002); SEC v. Rosenfeld, No. 97 Civ. 1467, 2001 WL 118612 (S.D.N.Y. Jan. 9, 2001); Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb, 734 F. Supp. 1071 (S.D.N.Y. 1990); and then citing SEC v. World Gambling Corp., 555 F. Supp. 930 (S.D.N.Y. 1983)).

includes obvious overhead expenses,<sup>210</sup> the wealth of evidence in relevant restatements and other secondary precedent,<sup>211</sup> and even the SEC's own filing in the lower court case in *Liu*<sup>212</sup> all demonstrate support for the practice of deducting at least some overhead.

The allowable business expenses will vary depending on the accounting method used. For instance, the way that GAAP accounting recognizes and organizes information is different from managerial cost accounting because it achieves a very different purpose. GAAP accounting is used for external purposes to provide accurate financial statements and disclosures for use by stakeholders,<sup>213</sup> whereas managerial cost accounting is used for internal tracking and budgetary purposes to track the costs incurred in production, such as material, labor, and overhead expenses.<sup>214</sup>

Further, GAAP accounting does not match costs with revenues to the same degree of granularity as cost accounting, nor does it necessarily do so in the same way.<sup>215</sup> Cost accounting may track revenues and expenses by individual product, product line, or revenue stream, depending on the sophistication of a company's cost accounting system.<sup>216</sup>

It may also prove to be the case that other alternatives to GAAP accounting may provide a more accurate estimate of the net profits concept intended by the Court in *Liu*<sup>217</sup> than GAAP, such as IFRS, regulatory, or tax accounting.

Some decisions made in the on-going development of GAAP are made for reasons of broad policy, like inter-firm comparability or consistency, while other choices are not relevant to a particular determination of net profits in a disgorgement calculation.<sup>218</sup>

Managerial cost accounting estimates may provide a better estimate of net profits for the purposes intended by the *Liu* test because managerial cost accounting might better ensure that all expenses associated with a stream of revenue are properly

<sup>210</sup> See *supra* text accompanying note 202.

<sup>211</sup> See *supra* text accompanying notes 120, 138.

<sup>212</sup> See *supra* text accompanying note 207.

<sup>213</sup> Fernando, *supra* note 113.

<sup>214</sup> See Tuovila, *supra* note 78.

<sup>215</sup> Compare Tuovila, *supra* note 111, with David Luther, *Cost Accounting Defined: What It Is & Why It Matters*, NETSUITE (July 25, 2023), <https://www.netsuite.com/portal/resource/articles/accounting/cost-accounting.shtml> [<https://perma.cc/3XGL-TG79>].

<sup>216</sup> See Luther, *supra* note 215.

<sup>217</sup> See *Liu v. SEC*, 591 U.S. 71, 75 (2020).

<sup>218</sup> See Brooke Tomasetti, *Generally Accepted Accounting Principles (GAAP)*, CARBON COLLECTIVE, <https://www.carboncollective.co/sustainable-investing/gaap> [<https://perma.cc/RRW2-2JCV>] (Aug. 21, 2024).

deducted.<sup>219</sup> Therefore, the disgorgement does not end up becoming a penalty prohibited by *Liu*.

Further, cost accounting may prove an important supplement to a net profits analysis using GAAP because cost accounting can match costs to particular lines of revenue<sup>220</sup> with a level of particularity that is not required by GAAP or Regulation S-X for presentation in the financial statements.<sup>221</sup> This method would provide management a window into the efficiency and performance tracking of the production process and help to separate out costs so that appropriate costs can be matched with related tainted lines of revenue for purposes of a *Liu* net profits analysis.

Managerial cost accounting is an internal costing system used to measure the costs of production, determine the profitability of individual products or departments, or implement cost controls (i.e., by comparing to budgets or standards).<sup>222</sup> Cost accounting is generally comprised of three types of costs: materials, labor, and overhead.<sup>223</sup> Materials costs include the direct expenses incurred to produce a product, such as raw materials, supplies, or other items closely associated with a specific product or process.<sup>224</sup> Labor costs are those direct expenses incurred to transform raw materials and supplies into a final product, such as the wages, direct supervision, or inspection of the production process.<sup>225</sup> Overhead costs are those indirect production costs that are difficult to trace to individual products without some form of estimation or allocation.<sup>226</sup>

For example, a manufacturing plant incurs expenses such as rent, utilities, insurance, machine maintenance, and property taxes.<sup>227</sup> However, these expenses are difficult to allocate to individual product lines or revenue streams without using some kind of estimation or allocation method.<sup>228</sup>

Costs can be classified further into fixed costs and variable costs. Fixed costs do not change significantly between accounting periods and are based on the particular number of goods produced (assuming

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<sup>219</sup> See Luther, *supra* note 215.

<sup>220</sup> See *id.*

<sup>221</sup> Compare *id.*, with PWC, *supra* note 47, at 1-2–1-4.

<sup>222</sup> See Tuovila, *supra* note 78.

<sup>223</sup> Luther, *supra* note 215.

<sup>224</sup> See *id.*

<sup>225</sup> See *id.*

<sup>226</sup> See *id.*

<sup>227</sup> See SURENDRA P. AGRAWAL, JAMES A. BRIMSON & MUKUL GUPTA, BLOOMBERG L., TAX AND ACCOUNTING PORTFOLIO 5306: ACTIVITY-BASED COSTING AND MANAGEMENT pt. II.A.4 (2024) (discussing activity costs and cost drivers generally).

<sup>228</sup> See *id.*

a particular level of production capacity) during any given period.<sup>229</sup> Variable costs, on the other hand, are tied closely to the units of production and will change significantly between accounting periods based on the particular number of goods produced during any given period.<sup>230</sup>

The difference between fixed costs and variable costs is not as concrete as it may first appear because the categories overlap. Over a long enough timeframe, even fixed costs become variable costs since those costs relate to items that can be readily replaced only over a longer timeframe.<sup>231</sup>

In the disgorgement context, variable costs may prove more relevant when a specific tainted revenue stream is being considered. Fixed costs may prove more important to include when taking a whole firm approach. One example is where there is an FCPA issue involving a subsidiary. It could also be important for a firm where the disgorgement is the capital raised for general operations. This could also be true when a particular division in which wrongdoing occurred relied on readily matchable fixed costs, in which case both variable and fixed costs may be included, and the distinction between them may prove less important.

Overhead costs are typically allocated in one of two ways: (1) volume-based allocation (typically using a single cost driver such as direct labor hours or machine hours), or (2) activity-based allocation (which refines traditional volume-based costing and allocates at a more granular level based on multiple cost pools, cost drivers, and rates).<sup>232</sup>

For heavy production companies, methods of allocating overhead costs to work in production and more complex methods of determining the cost of goods manufactured may be necessary. One method is process costing, which allocates an average cost per unit to a large number of units.<sup>233</sup> An allocation for overhead costs is included in the per unit cost, which may use estimates like FIFO or weighted average to track cost allocation as units move through the production cycle.<sup>234</sup>

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<sup>229</sup> See Luther, *supra* note 215.

<sup>230</sup> See *id.*

<sup>231</sup> Sarah Thomas, *Are There Fixed Costs in the Long Run?*, OUTLIER (July 20, 2022), <https://articles.outlier.org/long-run-fixed-costs> [<https://perma.cc/4KXF-HGRR>].

<sup>232</sup> See *Volume Based Allocation*, FINCENT, <https://fincent.com/glossary/volume-based-allocation> [<https://perma.cc/3KW4-54MV>]; Kenton, *supra* note 121.

<sup>233</sup> See *Process Costing*, ACCOUNTINGTOOLS (June 23, 2024), <https://www.accountingtools.com/articles/process-costing-process-cost-accounting> [<https://perma.cc/9MBL-8ET9>].

<sup>234</sup> See *id.*

Process costing is typically used for homogenous or mass-produced products.<sup>235</sup> More nuanced cost accounting methods can be utilized, such as activity-based costing, which allocates fixed costs on a basis that is linked to the relative strain that a particular product places on overhead using some activity related to the item<sup>236</sup> (as opposed to allocating fixed costs on a per unit basis like in process costing).

Activity-based costing matches overhead with activities that closely correlate with the extent to which a particular type of item utilizes shared overhead.<sup>237</sup>

The basic process for activity-based costing will be to (1) identify cost drivers, including both cost centers and the activities that drive those centers, (2) accumulate the costs into cost pools, (3) trace indirect costs to activity centers that can be assigned without allocation, (4) allocate remaining indirect cost pools, (5) divide assigned cost by activity level for the cost center, and (6) cost the product when sold.<sup>238</sup>

A cost driver is typically a class of activity that is thought to be correlated with how a business incurs overhead and is used to allocate overhead to particular cost pools.<sup>239</sup> After identifying cost drivers, costs are accumulated into cost pools.<sup>240</sup> A cost pool is a group of costs (such as direct labor or direct materials) for a specific center (such as a department, plant, or product line) to which costs are assigned or allocated.<sup>241</sup>

The categories of overhead cost pools utilized by management in managerial oversight<sup>242</sup> may be used for these purposes as well. More complicated joint costing issues may arise when the same elements of the production process are shared by multiple units.<sup>243</sup>

#### *D. Alternative Methods: Tax, Regulatory, or IFRS Accounting*

US firms use GAAP promulgated by the Financial Accounting Standards Board (FASB)<sup>244</sup> while international firms utilize the

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<sup>235</sup> *Id.*

<sup>236</sup> See Kenton, *supra* note 121.

<sup>237</sup> See *id.*

<sup>238</sup> See *id.*

<sup>239</sup> See AGRAWAL ET AL., *supra* note 227, pt.II.A.4.

<sup>240</sup> See *id.*

<sup>241</sup> See *id.*

<sup>242</sup> See generally *Overhead Cost Pool: Optimizing Cost Allocation Through Overhead Cost Pools*, FASTERCAPITAL, <https://fastercapital.com/content/Overhead-cost-pool--Optimizing-Cost-Allocation-through-Overhead-Cost-Pools.html> [<https://perma.cc/S3G5-CMQL>] (June 13, 2024).

<sup>243</sup> See Maria Silvia Avi, *Joint Costs: Evaluation Problems and Solutions*, GLOB. J. MGMT. & BUS. RSCH., 2023, at 1, 4–6.

<sup>244</sup> Fernando, *supra* note 113.

standards issued by the IFRS Foundation.<sup>245</sup> Some global companies operating and listed in both the United States and globally might use both accounting standards.<sup>246</sup> For some companies in this position, it may be necessary to select between the two methodologies or to utilize aspects of each to determine the appropriate measure of disgorgeable net profits.

One way in which these two methods differ is in impairment accounting. Impairment occurs when the carrying value of an asset exceeds the amount an entity expects to recover upon sale.<sup>247</sup> An impairment charge may be recognized under GAAP or IFRS and is typically reflected as a loss on the income statement.<sup>248</sup> However, differences arise in the context of reversing impairment charges.

GAAP does not permit reversal of impairment charges, whereas IFRS requires reversal of an impairment charge to reflect subsequent changes in the amount an entity expects to collect upon disposition.<sup>249</sup> Under IFRS, the financial statement impact of this reversal would be that any amount previously recognized as an impairment loss is recognized in profit or loss, and any excess would flow into OCI.<sup>250</sup>

There are also significant differences between GAAP and IFRS for the purposes of revenue recognition. Under GAAP, revenue recognition occurs when the nature, amount, and timing of revenues are known and when it is probable that substantially all of the revenues and cash flows will be collected.<sup>251</sup> The amount of revenue recognized should reflect the amount the entity expects to receive for the good/service.<sup>252</sup> Recognition typically takes place when the performance obligation has been satisfied.<sup>253</sup> Certain items, such as leases, insurance, financial instruments, and non-warranty guarantees, are covered by other revenue recognition rules.<sup>254</sup>

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<sup>245</sup> *Id.*

<sup>246</sup> See PWC, *supra* note 175, at 1-2–1-3.

<sup>247</sup> ACCT. STANDARDS CODIFICATION 360-10-35-15, -17 (FIN. ACCT. STANDARDS BD. 2023) (describing impairment and how to measure an impairment loss for long-term assets).

<sup>248</sup> See Alicia Tuovila, *Impaired Asset: Meaning, Causes, How to Test, and How to Record*, INVESTOPEDIA (<https://www.investopedia.com/terms/i/impairedasset.asp>) [<https://web.archive.org/web/20240821085746/https://www.investopedia.com/terms/i/impairedasset.asp>] (June 4, 2024).

<sup>249</sup> ACCT. STANDARDS CODIFICATION 360-10-35-20 (“Restoration of a previously recognized impairment loss is prohibited.”); see INT’L ACCT. STANDARDS 36 ¶¶ 110, 114 (INT’L ACCT. STANDARDS BD. 2024) (requiring businesses to reverse previously recognized impairment losses where recoverable amount changes in subsequent accounting periods).

<sup>250</sup> INT’L ACCT. STANDARDS 36 ¶¶ 126, 129.

<sup>251</sup> See ACCT. STANDARDS CODIFICATION 606-10-05-4.

<sup>252</sup> *Id.* 606-10-05-3.

<sup>253</sup> *Id.* 606-10-25-23.

<sup>254</sup> See *id.* 606-10-15-2.

Under IFRS, the guidelines for revenue recognition are similar to GAAP but the timing of revenue recognition under IFRS has slight distinctions from that of GAAP. Certain conditions must be met before revenue recognition can occur. First, full risks of ownership must have been transferred to the consumer.<sup>255</sup> Second, the management of the goods must have been outside the seller's control, and the seller must have already received an economic benefit.<sup>256</sup> Further, the amount that will be recognized as revenue must be reasonably measured.<sup>257</sup>

Additionally, there are fairly significant differences in the collectability thresholds for GAAP and IFRS. Under GAAP, an item's collectability must be "probable" before the entity can recognize it on its financial statements.<sup>258</sup> "Probable," under GAAP, has been defined as "likely to occur."<sup>259</sup> Under IFRS, an entity must also determine that the collectability of an item is "probable."<sup>260</sup> However, under IFRS, "probable" has been defined as the ability to "more likely than not" collect the consideration at issue.<sup>261</sup> In general, this will tend to result in earlier revenue recognition under IFRS when compared to GAAP.

One study revealed consistent differences in net income for companies reporting under IFRS in comparison to those reporting under GAAP.<sup>262</sup> The study evaluated, *inter alia*, U.S. subsidiaries of companies following IFRS.<sup>263</sup> The study found that the use of "IFRS allow[ed] most of the companies in [the] sample to report higher profitability," in a relevant amount, than when a company engaged in reporting under GAAP.<sup>264</sup> This trend will, of course, not be true for each individual company but demonstrates a general trend that IFRS reporting tends to result in higher net incomes.

There are further differences between GAAP accounting and income tax accounting. Since the methods of arriving at a net profits disgorgement merely require the use of a reasonable and objective methodology,<sup>265</sup> this established methodology (and other methods of

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<sup>255</sup> See INT'L ACCT. STANDARDS 15 ¶ 31.

<sup>256</sup> See *id.* 15 ¶ 35.

<sup>257</sup> See *id.* 15 ¶ 54.

<sup>258</sup> See ACCT. STANDARDS CODIFICATION 606-10-25-1(e).

<sup>259</sup> *Id.* 450-20-20.

<sup>260</sup> INT'L ACCT. STANDARDS 15 ¶ 9(e).

<sup>261</sup> See *id.* 37 ¶ 23.

<sup>262</sup> Elaine Henry, Stephen Lin & Ya-wen Yang, *The European-U.S. "GAAP Gap": IFRS to U.S. GAAP Form 20-F Reconciliations*, 23 ACCT. HORIZONS 121, 123-24 (2009).

<sup>263</sup> See *id.* at 126.

<sup>264</sup> *Id.* at 124.

<sup>265</sup> See *supra* text accompanying note 27.

regulatory accounting used for banks or for utilities) may, in some circumstances, be appropriate tools as part of a *Liu* net profits analysis.

For GAAP, an asset is typically capitalized at its historical cost and depreciated over its useful life.<sup>266</sup> For tax purposes, an asset is typically depreciated more quickly (due to a shorter useful life) under the Modified Accelerated Cost Recovery System (MACRS).<sup>267</sup>

For tax purposes, businesses may deduct ordinary and necessary business expenses, including a deduction for depreciation expenses.<sup>268</sup> Further, the Tax Cuts and Jobs Act (TCJA)<sup>269</sup> implemented, among other things, two additional forms of depreciation that may be deducted for tax purposes. Bonus depreciation allows a tax deduction for 100% of the cost of certain business assets.<sup>270</sup> Separately, Section 179 allows a tax deduction for certain depreciable assets, such as machinery, equipment, or qualified real property, in the tax year the assets are placed into service.<sup>271</sup>

Previously, bonus depreciation was allowed in the amount of 50% of depreciable tangible personal property placed into service before 2017.<sup>272</sup> However, as a result of TCJA, 100% bonus depreciation is allowed for property placed into service after September 17, 2017, and before 2023.<sup>273</sup> The bonus depreciation will be phased down beginning in 2023.<sup>274</sup> It will be limited to 80% for properties placed into service during 2023, 60% for properties placed into service during 2024, 40% for properties placed into service during 2025, and 20% for properties placed into service in 2026.<sup>275</sup>

Under Section 179, a business can deduct the cost of qualifying property up to a maximum of \$1 million per year, but the property

<sup>266</sup> See ACCT. STANDARDS CODIFICATION 360-10-35-4, 835-20-05-1 (FIN. ACCT. STANDARDS BD. 2023).

<sup>267</sup> See *MACRS Depreciation*, CORP. FIN. INST., <https://corporatefinanceinstitute.com/resources/accounting/macrs-depreciation/> [https://perma.cc/8E67-CKXU].

<sup>268</sup> I.R.C. §§ 162(a), 167(a).

<sup>269</sup> Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (codified at I.R.C.).

<sup>270</sup> See I.R.C. § 168(k) (noting that bonus depreciation will phase out beginning Jan. 1, 2023).

<sup>271</sup> See I.R.C. § 179(a), (d). Qualified real property is typically the most important item of the ones listed, as it's not eligible for bonus depreciation. See *Bonus Depreciation Rules, Recovery Periods for Real Property and Section 129 Expensing*, BAKER TILLY (July 20, 2022), <https://www.bakertilly.com/insights/bonus-depreciation> [https://perma.cc/EL6K-KLXZ]. "Qualified real property" is defined in Section 179(e) of the Internal Revenue Code.

<sup>272</sup> See Don Leatherman, *The Treatment of Corporations and Partnerships Under the TCJA*, 19 TRANSACTIONS 509, 535–36 (2018).

<sup>273</sup> I.R.C. § 168(k).

<sup>274</sup> See *id.* § 168(k)(6)(A).

<sup>275</sup> See *id.*

must have been placed into service after 2017.<sup>276</sup> The deduction amount will be reduced to the extent that the amount placed into service in any given year exceeds \$2.5 million.<sup>277</sup>

#### 1. Differences in Treatment of R&D for GAAP (Not Expensed) and Tax (Expensed)

Research and development expenses are another form of costs incurred by companies that can potentially affect net income<sup>278</sup> and, thus, impact the net profits calculation for purposes of disgorgement. The ultimate impact of R&D expenses on a disgorgement calculation will ultimately depend on the accounting method used by the company.

As a preliminary matter, research costs are typically defined as those where a company gains new information and where substantially all of the research is for the purpose of discovering or obtaining information on “a new or improved function, . . . performance, or . . . quality.”<sup>279</sup> Research that is substantially for the purpose of improving style or cosmetic factors would not qualify as research expenses.<sup>280</sup> Development expenses typically involve those incurred to significantly improve an existing product or process.<sup>281</sup> Section 41 of the Internal Revenue Code refers to the development phase as “experimentation.”<sup>282</sup>

Under GAAP, R&D expenses are generally expensed in the tax year where incurred.<sup>283</sup> This differs from the treatment of R&D expenses under IFRS, which requires companies to capitalize on certain development costs, so long as the development will become commercially viable.<sup>284</sup> This concept of capitalization refers to the recording of an item on a company’s balance sheet.<sup>285</sup> Capitalization does not impact a company’s income statement unless the item is

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<sup>276</sup> See *id.* § 179(a), (b)(1).

<sup>277</sup> *Id.* § 179(b)(2).

<sup>278</sup> See *Capitalizing R&D Expenses*, CORP. FIN. INST., <https://corporatefinanceinstitute.com/resources/accounting/capitalizing-rd-expenses/> [https://perma.cc/QW72-PHPH].

<sup>279</sup> See I.R.C. § 41(d)(1), (d)(3)(A).

<sup>280</sup> *Id.* § 41(d)(3)(B).

<sup>281</sup> See *id.* § 41(d)(3)(A).

<sup>282</sup> *Id.* § 41(d)(1)(C).

<sup>283</sup> ACCT. STANDARDS CODIFICATION 730-10-25-1 (FIN. ACCT. STANDARDS BD. 2023).

<sup>284</sup> See INT’L ACCT. STANDARDS 38 ¶¶ 5, 21 (INT’L ACCT. STANDARDS BD. 2024).

<sup>285</sup> Adam Hayes, *Capitalize: What It Is and What It Means When a Cost Is Capitalized*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/capitalize.asp> [https://web.archive.org/web/20240822050456/https://www.investopedia.com/terms/c/capitalize.asp] (June 24, 2024).

depreciated or amortized.<sup>286</sup> For purposes of disgorgement accounting, this would mean expenses that are capitalized will not impact the net profits calculation.

The alternative to capitalization of an expense is to incur the item as an expense on a company's income statement instead.<sup>287</sup> Once a company incurs an item as an expense on its income statement, it will affect its net income,<sup>288</sup> thus, impacting the company's net profits disgorgement calculation.

For federal income tax purposes, R&D expenses have historically been treated as fully deductible in the taxable year the expenses were incurred.<sup>289</sup> However, one of the delayed provisions of the Tax Cuts and Jobs Act of 2017 altered the treatment of R&D expenses.

For tax years beginning after December 31, 2021, certain research and experimental expenses are not deductible and must be capitalized and amortized ratably over a five-year period.<sup>290</sup> The five-year period is calculated using a half-year convention, meaning that the time period begins at the midpoint of the taxable year, where the research and experimental expenses are either paid or incurred.<sup>291</sup>

While the R&D costs eventually deducted under tax and GAAP will be the same in the long run, the treatment under tax and GAAP results in important timing differences in the interim. Under the old treatment of R&D costs, a deduction was allowed for tax purposes typically much sooner than the expense appeared on a company's income statement under GAAP. However, the post-2021 treatment of research and experimental costs will delay these deductions for tax purposes.

## 2. Regulatory Accounting

Regulatory accounting is another accounting method that could potentially impact a net profits calculation for disgorgement purposes. Companies commonly use regulatory accounting in heavily regulated industries such as insurance, public utilities, banking, or

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<sup>286</sup> *See id.*

<sup>287</sup> *See* Expenses, CORP. FIN. INST., <https://corporatefinanceinstitute.com/resources/accounting/expenses/> [https://perma.cc/7GPM-K6DX].

<sup>288</sup> *See id.*

<sup>289</sup> Internal Revenue Code of 1954, Pub. L. No. 83-736, § 174(a), 68A Stat. 3, 66 (prior to 2017 amendment).

<sup>290</sup> Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13206(a), (e), 131 Stat. 2054, 2111 (amending I.R.C. § 174).

<sup>291</sup> *See* Tax Cuts and Jobs Act of 2017 § 13206(a)(2)(B), 131 Stat. at 2111.

mutual funds.<sup>292</sup> Revenue and expense recognition for regulatory accounting differs in several important ways from GAAP, IFRS, or tax purposes, and how these differences result in a different net income estimate for purposes of a disgorgement calculation will be discussed below.

First, companies using regulatory accounting may capitalize the costs they incur as a “regulatory asset,” so long as the costs are probably recoverable through the rates charged to the company’s customers.<sup>293</sup> This is distinct from most other accounting methods, where the vast majority of costs are expensed.<sup>294</sup> Following capitalization, the incurred costs can be found in an account on the company’s balance sheet.<sup>295</sup> Over time, this balance sheet account balance will be amortized as rates are recovered from customers.<sup>296</sup> When an item is amortized, the amount amortized will ultimately show up on the company’s income statement as an expense (i.e., resulting in an overall decrease in net income).<sup>297</sup>

To the extent that it is not probable that certain incurred costs will be recovered from rates charged to customers, regulatory accounting requires these costs to be expensed.<sup>298</sup> This broad capitalization of costs onto the company’s balance sheet would likely result in a much lower net income for disgorgement purposes.

#### *a. Bank Regulatory Accounting*

Bank stress tests<sup>299</sup> reveal that companies with total trading assets of \$10-50 billion should follow certain principles and methods for loss estimation, revenue estimation, and recognition of certain

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<sup>292</sup> See ALAN S. GLAZER & GLENN L. STEVENS, BLOOMBERG L., TAX AND ACCOUNTING PORTFOLIO 5122-3RD: FINANCIAL STATEMENT ANALYSIS, QUALITATIVE TECHNIQUES pt. III.C (2024).

<sup>293</sup> See ACCT. STANDARDS CODIFICATION 980-340-25-1 (FIN. ACCT. STANDARDS BD. 2023).

<sup>294</sup> See GLAZER & STEVENS, *supra* note 292, pt. VI.G.2.

<sup>295</sup> Alicia Tuovila, *Capitalized Cost: Definition, Example, Pros and Cons*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/capitalizedcost.asp> [<https://perma.cc/8SSP-CK2L>] (May 1, 2023).

<sup>296</sup> See *id.*

<sup>297</sup> See *id.*

<sup>298</sup> See ACCT. STANDARDS CODIFICATION 980-10-20 (defining incurred versus allowable costs, showing the distinction between those that are incurred (i.e., usually capitalized) and allowable (i.e., usually allowed to incur as an expense on the income statement)).

<sup>299</sup> See Troy Segal, *What Is a Bank Stress Test? How It Works, Benefits, and Criticism*, INVESTOPEDIA, <https://www.investopedia.com/terms/b/bank-stress-test.asp> [<https://web.archive.org/web/20240822133743/https://www.investopedia.com/terms/b/bank-stress-test.asp>] (Oct. 28, 2021).

expenses.<sup>300</sup> These principles, known as pre-provision net revenue (PPNR), are estimation standards used to collect internal data and estimate revenues within specific business lines.<sup>301</sup> The three main PPNR disclosure categories are net interest income, non-interest income, and non-interest expense.<sup>302</sup>

In one bank stress test report, regulators advised these larger companies to utilize “more advanced techniques that identify the specific drivers of revenue and [to] analyz[e] how the supervisory scenarios affect those revenue drivers.”<sup>303</sup> In describing these “advanced techniques,” the guidance continually emphasized that a company’s choice as to revenue and expense recognition should maximize “credib[ility] and reflect a reasonable translation of expected outcomes consistent with the key scenario variables.”<sup>304</sup>

From this report, it becomes quite clear that bank regulators are encouraging companies following principles of bank regulatory accounting to use a modified version of cost accounting<sup>305</sup> for some bank regulatory accounting approaches. Further, regulators are especially encouraging these companies to develop an activity-based costing system,<sup>306</sup> as demonstrated by the stress test’s continual references to “revenue drivers” and the “advanced technique[]” that more accurately recognizes expenses based on “specific drivers” and “specific business lines.”<sup>307</sup>

One stress test describes various loss recognition recommendations. For example, it advises companies to estimate and disclose separately “credit losses associated with loan portfolios and securities holdings.”<sup>308</sup> Whereas other types of losses, such as trading losses and losses associated with requests by mortgage investors, should be included in PPNR and estimated under the non-interest expense component.<sup>309</sup>

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<sup>300</sup> See Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of More than \$10 Billion but Less than \$50 Billion, 79 Fed. Reg. 14153, 14162 (Mar. 13, 2014) (to be codified at 12 C.F.R. pt. 325).

<sup>301</sup> See *id.* at 14156.

<sup>302</sup> *Id.*

<sup>303</sup> *Id.* at 14165.

<sup>304</sup> See *id.*

<sup>305</sup> See *supra* text accompanying note 222.

<sup>306</sup> See *supra* text accompanying note 238.

<sup>307</sup> See Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of More than \$10 Billion but Less than \$50 Billion, 79 Fed. Reg. at 14165.

<sup>308</sup> *Id.*

<sup>309</sup> See *id.* at 14165.

Additionally, certain revenue recognition standards are triggered for companies with \$10 million or more total trading assets.<sup>310</sup> These entities are required to recognize trading revenue from interest rate exposures, foreign exchange exposures, equity security and index exposures, commodity exposures, and credit exposures.<sup>311</sup>

For businesses following U.S. GAAP, recent developments regarding the disaggregation of income and expenses could impact a disgorgement accounting calculation. Traditionally, GAAP has not required that certain categories of assets or expenses include a detailed breakdown of the particular costs or line items contained within the broader asset or expense category.<sup>312</sup> But in recent years, various initiatives have advocated for more detailed disclosures in particular categories, such as the compensation of employees, certain inventory expenses, and depreciation and amortization expenses.<sup>313</sup>

On January 11, 2023, the FASB reached a decision as to the information that businesses must provide when disaggregating expenses on the income statement.<sup>314</sup> As part of the FASB's Disaggregation—Income Statement Expenses, or DISE, project, it declared that entities are now required to include employee compensation, PP&E depreciation, the amortization of intangibles, and certain inventory expenses as line items within their financial statements.<sup>315</sup> As of now, the new disaggregation project will require businesses to disclose these expenses in the notes of the financial statements.<sup>316</sup>

Additionally, the project will require disaggregation of certain items capitalized on a company's balance sheet.<sup>317</sup> The categories are similar to those implicated by the income statement disaggregation listed above and include disaggregation of purchases of inventory, employee compensation, depreciation of property, PP&E, and amortization of certain intangibles.<sup>318</sup>

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<sup>310</sup> See Agency Information Collection Activities, 83 Fed. Reg. 939, 965 (Jan. 8, 2018).

<sup>311</sup> *Id.*

<sup>312</sup> See DIV. OF CORP. FIN., SEC. & EXCH. COMM'N, CURRENT ACCOUNTING AND DISCLOSURE ISSUES IN THE DIVISION OF CORPORATE FINANCE 55–56 (2006).

<sup>313</sup> See Soyoung Ho, *FASB Plans to Require More Detailed Disclosures of Income Statement Expenses*, THOMSON REUTERS (Jan. 18, 2023), <https://tax.thomsonreuters.com/news/fasb-plans-to-require-more-detailed-disclosures-of-income-statement-expenses/> [<https://perma.cc/2C5M-8LSA>].

<sup>314</sup> See Memorandum from the Disaggregation—Income Statement Expenses Project Team to the Fin. Acct. Standards Bd. Members 1, 2 (Jan. 13, 2023) (on file with FASB).

<sup>315</sup> *Id.* at 2.

<sup>316</sup> *Id.* at 3.

<sup>317</sup> See *id.* at 2.

<sup>318</sup> *Id.*

The effect that this disaggregation of expenses project will ultimately have on businesses is still somewhat uncertain until the plan's final version is released.

#### IV. VALUATION AND STOCK PRICE IMPACT STUDIES

Much of the *Liu* accounting analysis focuses on the case of corporate defendants.<sup>319</sup> The analysis may take on a very different character in cases with an individual defendant whose stock trading revenues were illicitly obtained, either in whole or in part.

Writing prior to the *Liu* decision, Buckberg and Dunbar noted that disgorgement in net trader cases is measured as a test of the net gain from illicit conduct.<sup>320</sup> They point to individual trader securities cases that compare net trading gains and losses against each other to determine the net disgorgeable amount.<sup>321</sup>

This is a different disgorgement calculation from that likely to be undertaken for corporate defendants. Individual trader cases will net gains and losses from trading because individuals will be more actively trading in securities.<sup>322</sup> Individuals are also likely to have fewer expenses other than some trading fees.<sup>323</sup>

On the other hand, companies are not likely trading in securities as part of a fraud or other securities violation, yet they potentially will have significant expenses to deduct from the gross proceeds associated with a fraud.<sup>324</sup> Buckberg and Dunbar focus their analysis on the individual defendant as they suggest utilizing the stock price impact tool to measure disgorgement.<sup>325</sup>

The issue that remains post-*Liu* is determining net profits at the corporate level for corporate defendants. Some of the concepts from individual shareholder disgorgement determinations might carry over to this context; in other instances they may not. The uncertainties surrounding determinations of legitimate expenses to

<sup>319</sup> See Schulp, *supra* note 2, at 211.

<sup>320</sup> Buckberg & Dunbar, *supra* note 90, at 349.

<sup>321</sup> See *id.* at 354–56.

<sup>322</sup> See Cory Mitchell, *Active Trading: Meaning, Strategies, Example*, INVESTOPEDIA <https://www.investopedia.com/terms/a/active-trading.asp> [https://perma.cc/QM8E-HNZF] (Sept. 30, 2022); Kristina Zucchi, *Institutional Traders vs. Retail Traders: What's the Difference?*, INVESTOPEDIA <https://www.investopedia.com/articles/active-trading/030515/what-difference-between-institutional-traders-and-retail-traders.asp> [https://perma.cc/24BD-KRU7] (Dec. 14, 2023).

<sup>323</sup> See Gordon Scott, *Best Day Trading Platforms of 2024*, INVESTOPEDIA, <https://www.investopedia.com/best-brokers-for-day-trading-4587880> [https://perma.cc/QHZ7-84WW] (Aug. 17, 2024).

<sup>324</sup> See I.R.C. § 162(a).

<sup>325</sup> See Buckberg & Dunbar, *supra* note 90, at 361–62.

subtract from disgorgement awards are more unique in the corporate context.<sup>326</sup>

Buckberg and Dunbar also point to the market efficiency concept utilized in other aspects of the federal securities laws to argue that the concept should be used in some cases to demonstrate disgorgeable profits.<sup>327</sup> They note that courts have used an assumption of market efficiency—that the impact of information on stock prices is quickly incorporated into the stock price—in approving disgorgement awards.<sup>328</sup>

Market valuation methods<sup>329</sup> may be incorporated into some particular types of disgorgement calculations. Take, for example, the case of a subsidiary whose principal source of revenue is a government contract that is determined to have been obtained from an FCPA violation. If that subsidiary is publicly traded, and if the parent company is buying and selling shares in the subsidiary, then the change in value of the company stock from the announcement of the contract award and the announcement about the investigation could be utilized as part of the price inflation/stock price event study methodology to determine the net change in stock value.

In a case in which the subsidiary has been purchased or sold during the time frame of a fraud or FCPA violation occurring at the subsidiary, it may become necessary to use a stock price impact calculation and/or valuation methodologies to determine net gain. For a subsidiary that is publicly traded and controlled by the parent company, that may require use of a stock price event study if the company is publicly traded to isolate the net impact of the illicit activity on stock price from other factors that impacted it.

For a subsidiary that is not publicly traded, it may be necessary to rely on valuation measures that can be used to translate expected future revenues from the fraud and their associated expenditures utilizing a discounted cash flow (DCF) or capitalization methodology.<sup>330</sup> The baseline value of the subsidiary against which to compare this value would be found using a DCF methodology that

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<sup>326</sup> See Julia Kagan, *Understanding Business Expenses and Which Are Tax Deductible*, INVESTOPEDIA, <https://www.investopedia.com/terms/b/businessexpenses.asp> [<https://web.archive.org/web/20240822164742/https://www.investopedia.com/terms/b/businessexpenses.asp>] (Aug. 5, 2024).

<sup>327</sup> See Buckberg & Dunbar, *supra* note 90, at 359–62.

<sup>328</sup> See *id.* at 359–61, 359 n.82.

<sup>329</sup> See Patel, *supra* note 130.

<sup>330</sup> See generally, *Discounting vs. Capitalizing: Two Popular Earnings-Based Valuation Methods at a Glance*, KPM CPAS & ADVISORS (Jan. 23, 2023), <https://www.kpmcpa.com/discounting-vs-capitalizing-two-popular-earnings-based-valuation-methods-at-a-glance/> [<https://perma.cc/P2P5-XDLF>].

eliminates the net profits<sup>331</sup> associated with the fraudulent activity. The baseline subsidiary value may also be determined utilizing a market valuation like the comparative company method or the comparative transaction method.<sup>332</sup>

Buckberg and Dunbar summarize how courts have utilized stock price event studies in determining disgorgement amounts.<sup>333</sup> They proffer methods for determining net gains for recipients of bonus compensation and for individual traders in company stock, and use stock price impact studies to measure the difference between stock price changes from fraud, baseline changes in the “but for” scenario to determine returns if wrongdoing had not occurred, and determine the net gains by netting gains and losses from trading.<sup>334</sup> Their methods only become more useful post-*Liu*.

## V. UNIQUE FACT PATTERNS IN FCPA CASES

FCPA cases very rarely go to trial and have instead tended to settle by way of a Deferred Prosecution Agreement (DPA) or Non-Prosecution Agreement (NPA).<sup>335</sup> David Levintow argues that, since most FCPA cases settle out of court in this way, *Liu* may have limited impact on FCPA cases.<sup>336</sup> Yet these discussions, though settling frequently, still take place under the specter of a potential litigation, and SEC staff have publicly asked that defendants provide a detailed estimate of net profits in their negotiations with the SEC.<sup>337</sup> Given the scale of FCPA settlements and awards,<sup>338</sup> it would be prudent practice to provide a detailed estimate of net profits in an SEC FCPA negotiation, or any other major settlement discussion for that matter.

Levintow analyzes FCPA actions and finds that in a number of cases, parent companies seem to be held liable by the SEC for the FCPA violations of their subsidiaries in what appears to be a form of joint and several liability.<sup>339</sup> Yet joint and several liability is not

<sup>331</sup> See *id.*

<sup>332</sup> See generally Matt Lawver, *Business Valuation: Comparable Transaction Method*, QUANTIVE (Mar. 7, 2023), <https://goquantive.com/blog/business-valuation-comparable-transaction-method/> [<https://perma.cc/EPC3-RJRK>].

<sup>333</sup> See Buckberg & Dunbar, *supra* note 90, at 361–62.

<sup>334</sup> *Id.* at 357–58, 361–67, 378–80.

<sup>335</sup> Levintow, *supra* note 20, at 199.

<sup>336</sup> *Id.* at 199–200.

<sup>337</sup> DOJ & SEC RESOURCE GUIDE, *supra* note 161, at 78–79; see Matthew G. Lindenbaum, Robert L. Lindholm & Raymond J. Prince, *Liu v. SEC: One Year Later*, N.Y. L.J. (June 25, 2021, 2:40), <https://www.law.com/newyorklawjournal/2021/06/25/liu-v-sec-one-year-later/?slreturn=20220710151451> [<https://perma.cc/L5Q4-ZH3D>].

<sup>338</sup> See *SEC Enforcement Actions: FCPA Cases*, *supra* note 163.

<sup>339</sup> See Levintow, *supra* note 20, at 205–06.

permitted unless all parties are engaged in the wrongdoing when it comes to disgorgements under *Liu*; thus, Levintow argues that this aspect of *Liu* will have significant consequences for FCPA cases going forward.<sup>340</sup>

Levintow urges that the SEC may argue for FCPA cases that foreign bribery is the type of case in which all gross proceeds are disgorgeable because they are entirely the result of wrongdoing.<sup>341</sup> Levintow suggests this argument gets it wrong, and that even though the awarding of a contract may be the result of illicit bribes, the profit from the contract will result from the firm's performance under the contract, which requires legitimate expenditures that should therefore be deductible from any disgorgement amount.<sup>342</sup>

Levintow notes that in *Liu*, the gross proceeds were nearly entirely the result of fraud, and yet still sizable legitimate expenses were deemed deductible.<sup>343</sup> Levintow notes how the FCPA fact pattern often involves payments to third-party consultants and intermediaries, some of whom will be active participants in a bribe, and questions about whether the third-party payments are legitimate are not likely to arise.<sup>344</sup> Levintow lists a number of FCPA specific fact patterns in which third-party payments were at times a mixed combination of legitimate third-party payments and other payments that appeared to have furthered the bribery scheme.<sup>345</sup>

It is unclear whether interpretations of *Liu* will permit offsets from private litigation or criminal fines against the SEC's disgorgement amount; some cases have limited both offsets, though they were pre-*Liu*.<sup>346</sup> Given that FCPA cases often involve substantial overlap between SEC, DOJ, and international actions,<sup>347</sup> this may be a uniquely important interpretive question in the FCPA context.

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<sup>340</sup> See *id.* at 205–08.

<sup>341</sup> *Id.* at 210.

<sup>342</sup> *Id.* at 210–11.

<sup>343</sup> See *id.* at 211.

<sup>344</sup> *Id.* at 211–12.

<sup>345</sup> See *id.* at 212–13.

<sup>346</sup> See Kirk, *supra* note 54, at 144–45 & n.59 (citing SEC v. Penn Centr. Co., 425 F. Supp 593 (E.D. Pa. 1976); SEC v. Shah, No. 92 Civ. 1952, 1993 WL 288285 (S.D.N.Y. July 28, 1993); SEC v. Palmisano, 135 F.3d 860 (2d Cir. 1998)).

<sup>347</sup> See DOJ & SEC RESOURCE GUIDE, *supra* note 161, at 3–4, 6–8.

## VI. SETTLEMENT SUBMISSION GUIDELINES FOR DISGORGEMENT ACCOUNTING REPORT

### *A. Burden Shifted to Defendant Opens Role for Forensic Accountant*

The SEC must demonstrate a causal connection between the amount to be disgorged and the wrongful conduct.<sup>348</sup> On the other hand, when challenging the SEC's determination, a defendant is encouraged to incorporate expert testimony from a forensic accountant to demonstrate a viable alternative methodology for determining the disgorgable amount.<sup>349</sup>

If questions of expense legitimacy are being hashed out in court, the SEC will be required to meet an initial and limited burden of showing that the disgorgement it is seeking is a reasonable approximation of unlawful net profits.<sup>350</sup> Uncertainties in disgorgement calculations fall against the wrongdoer.<sup>351</sup> It is important to provide strong evidence of expenses, their connection to the revenues at issue, and their independence from the illicit character of the activity at issue, which can be best accomplished through an expert report.

Since most SEC litigation ends in settlement,<sup>352</sup> an expert report will similarly be essential in negotiations with the SEC. In a speech in 2020, former SEC Enforcement Division Chief Counsel, Joseph Brenner, said that defendants need to be prepared to provide substantive evidence of the legitimacy of an expense in discussions with the SEC.<sup>353</sup>

One leading Supreme Court case on disgorgement in a different context describes how disgorgement calculations only require a reasonable approximation using "the testimony of experts and persons informed by observation and experience."<sup>354</sup>

In *SEC v. Premier Holding*,<sup>355</sup> the court affirmed that business expenses not adequately demonstrated by the defendant will not be

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<sup>348</sup> See Buckberg & Dunbar, *supra* note 90, at 355.

<sup>349</sup> See *id.* at 351.

<sup>350</sup> See *SEC v. Calvo*, 378 F.3d 1211, 1217 (11th Cir. 2004).

<sup>351</sup> *E.g.*, *SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1096 (9th Cir. 2010) (quoting *SEC v. First City Fin. Corp.*, 890 F.2d 1215 (D.C. Cir. 1989)).

<sup>352</sup> See JEFFREY E. MCFADDEN & SAMANTHA KATS, STRADLEY RONAN, TO PLEA OR NOT TO PLEA: THAT IS NOT THE QUESTION, STRADLEY RONAN 2 (2017).

<sup>353</sup> See Lindenbaum, et al., *supra* note 337.

<sup>354</sup> See *Sheldon v. Metro-Goldwyn Pictures Corp.*, 309 U.S. 390, 404 (1940) (quoting *Dowagiac Mfg. Co. v. Minn. Moline Plow Co.*, 235 U.S. 641 (1915)).

<sup>355</sup> *SEC v. Premier Holding Corp.*, No. 21-55249, 2022 WL 541194 (9th Cir. Feb. 23, 2022).

deducted in a net profits calculation.<sup>356</sup> This case also reinforced the notion that the defendant bears the burden after the SEC has demonstrated a reasonable approximation of net profits.<sup>357</sup>

In *Sheldon v. Metro-Goldwyn Pictures Corp.*, the Court considered what portion of a movie's profit resulted from a copyright violation versus the ability of the actors and other non-violative work in a movie production.<sup>358</sup> The Court relied on the testimony of experts as to the relative share of profit attributable to the violation versus the share of profit not apportionable to the violation.<sup>359</sup> The Supreme Court in *Liu* has created a similar process for disgorgement determinations,<sup>360</sup> and other lower court cases have suggested the importance of utilizing experts for that purpose,<sup>361</sup> in this context, that would include forensic accountants.

Does the presumption that the SEC gets here, that defendants then must rebut, suggest anything about how this is calculated? Does that mean that defendants will need to make a stronger case by showing that the method used to measure net profits was also relied upon by the defendants? Is the burden on defendants to demonstrate which of the measures is more appropriate? Which metrics best serve which purposes, such as deterrence or taking away wrongfully acquired profits? Does the fact that tax or profit targets may have been more important in incentivizing the bad actors influence the disgorgeable amount? Why should GAAP reporting used in financials be the measure?

The lacking prevalence of undisputed law on this point means that expert reports ought to make the persuasive arguments that one of the accounting methodologies is reliable and is not simply selected because it generates the lowest disgorgement liability for the defendant. One way to demonstrate this objectivity would be to show that the methodology was previously utilized by the defendant either in their own non-GAAP internal managerial cost accounting or in their income tax or regulatory accounting. Alternatively, that the method or measure selected for the disgorgement award was also utilized by similar firms, or by providing some other objective evidence, may be presented in support of the expense methodology selected. The choice of disgorgement accounting methodologies may

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<sup>356</sup> See *id.* at \*1.

<sup>357</sup> See *id.*

<sup>358</sup> See *Sheldon*, 309 U.S. at 407–08.

<sup>359</sup> See *id.* at 406.

<sup>360</sup> See *Liu v. SEC*, 591 U.S. 71, 91–92 (2020).

<sup>361</sup> See, e.g., *Kars 4 Kids Inc. v. Am. Can!*, Nos. 3:14-cv-7770, 3:16-cv-4232, 2020 WL 1550804, at \*5 (D.N.J. Apr. 1, 2020).

otherwise be supported by arguments that better fit the precedent linked to *Liu* and better fit the purpose of disgorgement accounting.

## VII. CONCLUSION

The disgorgement remedy is traditionally one of the more powerful tools in the SEC's arsenal that the agency has used to obtain billions in settlement awards every year.<sup>362</sup> The overwhelming majority of cases brought by the SEC settle owing to the leverage the SEC has over enforcement targets.<sup>363</sup> The collateral costs to share price from pending enforcement,<sup>364</sup> the incentive to settle on behalf of a corporate defendant to avoid personal liability,<sup>365</sup> and the SEC's punitive authority to bar individuals from serving at a public company,<sup>366</sup> collectively result in the high rate of settlement. The awards resulting from the disgorgement remedy are negotiated at the settlement phase.<sup>367</sup>

The *Liu v. SEC* case changes the negotiating dynamics of settlement somewhat, in that the *Liu* case substantially curtails the SEC's discretion and sets a ceiling on a disgorgement award to the net profits obtained.<sup>368</sup> This will impact billions in annual awards and put forensic accounting questions front and center in these settlement negotiations and in any cases that ultimately proceed to trial.

The case also opens the door to several complex questions at the intersection of securities law and accounting. Or, more precisely, complex questions at the intersection of securities law on the one hand, and multiple fields of accounting on the other, including financial accounting, forensic accounting, and possible tax and other regulatory accounting.

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<sup>362</sup> See *supra* text accompanying note 1.

<sup>363</sup> See Mike Blankenship & Regina Maze, *A Look at Recent Challenges to SEC's Settlement 'Gag Rule'*, LAW360 (Apr. 3, 2024, 6:22 PM), <https://www.law360.com/articles/1819280> [<https://perma.cc/7SSD-UF2B>].

<sup>364</sup> See Gulnur Muradoglu & Jennifer Clark Huskey, *The Impact of SEC Litigation on Firm Value* 3 (Feb. 19, 2008) (unpublished manuscript) (on file with *Albany Law Review*).

<sup>365</sup> See generally Jeffrey P. Lewis, Note, *Avoiding Personal Liability on a Client's Contract*, PA. BAR NEWS., Mar. 19, 2012, at 4.

<sup>366</sup> See Philip F.S. Berg, *Unfit to Serve: Permanently Barring People from Serving as Officers and Directors of Publicly Traded Companies After the Sarbanes-Oxley Act*, 56 VAND. L. REV. 1871, 1873 (2003).

<sup>367</sup> See *Settlements and Disgorgement, Negotiating a Path to Resolution*, FASTERCAPITAL, <https://fastercapital.com/content/Settlements--Settlements-and-Disgorgement--Negotiating-the-Path-to-Resolution.html> [<https://perma.cc/2CLJ-HJLH>] (June 18, 2024).

<sup>368</sup> See Schulp, *supra* note 2, at 226.

The Supreme Court's brief reference to net profits opens up a host of questions about how to properly define net profits for this particular disgorgement purpose that will continue to be litigated and will require continued thoughtful leadership by consulting accountants.

This Article has sketched a map of those initial legal and accounting questions, providing securities attorneys and the forensic accountants that assist them an initial compass to begin to navigate the many interpretive questions that naturally flow from *Liu v. SEC*.