# Limiting SEC disgorgement

The law and accounting of "legitimate" expenses after *SEC v. Liu*

## I. Introduction

In June 2020, the United States Supreme Court held that the Securities and Exchange Commission has authority under the federal securities laws to seek disgorgement in federal courts as an equitable remedy, but that such awards must be limited to the defendants' net profits.[1] The court remanded the case for a determination of whether the damage award had been so restricted, providing only limited guidance on what "legitimate expenses" must be deducted from gross proceeds of the fraud to measure the ill-gotten gains subject to disgorgement.

One issue left open, for example, is how courts should treat the wrongdoer's overhead expenses—a decision perhaps best understood through an accounting lens. In this document, we combine the analyses of lawyers and accountants to explore *SEC v. Liu's* guidance as to "legitimate" expenses, and what accounting tells us about how the courts should approach several different scenarios involving different types of direct and indirect business expenses.

## II. *Liu* and the exclusion of "legitimate expenses" from disgorgeable net profits

Three years before deciding *Liu*, the Supreme Court held in *Kokesh v. SEC* that SEC disgorgement authority in federal courts was subject to a five-year statute of limitations. The court held that the SEC lacked the open-ended authority it had previously exercised to reach back to disgorge wrongful gains unchecked by any limitations period.[2] In *Liu*, the Supreme Court returned to address a threshold issue that the parties had not presented in *Kokesh*: whether the SEC had the power to impose a disgorgement remedy at all in furtherance of its general authority under the Securities Exchange Act of 1934 (Exchange Act) to seek "any equitable relief that may be appropriate or necessary for the benefit of investors."[3]

The *Liu* court held that disgorgement is, indeed, within the commission's equitable relief powers, but only if the disgorgement "does not exceed a wrongdoer's net profits and is awarded for victims."[4] And further, "courts may not enter disgorgement awards that exceed the gains 'made upon any business or investment, when both the receipts *and payments* are taken into the account.'"[5] The court noted that these limitations are inherent in a century of equity jurisprudence: "equity practice long authorized courts to strip wrongdoers of their ill-gotten gains," but "courts restricted the remedy to an individual wrongdoer's *net profits* to be *awarded for victims*."[6] A rule that "makes no allowance *for the cost and expense of conducting [a] business'* would be 'inconsistent with ordinary principles and practice of courts of chancery.'"[7] The exception to that rule is where the defendant's enterprise was entirely fraudulent: "when the 'entire profit of a business or undertaking' results from the wrongdoing, a defendant may be denied 'inequitable deductions' such as for personal services."[8]

1 *Liu v. SEC*, 140 S. Ct. 1936 (2020); *see* "U.S. Supreme Court Upholds, But Curtails, SEC's Disgorgement Authority in Enforcement Actions," Goodwin Procter LLP Client Alert (June 22, 2020), *available at* https://www.goodwinlaw.com/publications/2020/06/06_22-us-supreme-court-upholds-but-curtails.

2 *Kokesh v. SEC*, 137 S. Ct. 1635 (2017); *see* "United States Supreme Court Limits SEC Disgorgement," Goodwin Procter LLP Client Alert (June 5, 2017), *available* at https://www.goodwinlaw.com/publications/2017/06/united-states-supreme-court-limits-sec.

3 15 U.S.C. §78u(d)(5).

4 *Id.* at 1937.

5 *Id.* at 1950, quoting *Rubber Co. v. Goodyear*, 9 Wall. 788, 804, 19 L.Ed. 566 (1869) (emphasis added).

6 *Id.* at 1942.

7 *Id.*, quoting *Tilghman v. Proctor*, 125 U.S. 136, 145-146, 8. S. Ct. 894, 31 L.Ed. 664 (1888) (emphasis added).

8 *Id.* at 1950, quoting *Root v. Railway Co.*, 105 U.S. 189, 203, 26 L.Ed. 975 (1881).

Beyond saying that "legitimate expenses" should be deducted, the court did not explain which expenses should be deducted from amounts to be disgorged. In the case before it, the defendants had raised $27 million from investors for the disclosed purpose of building a cancer treatment center, and then diverted some $20 million of the proceeds to personal accounts, a company controlled by one of the husband-wife defendants and ostensible marketing expenses. The court's sole indication as to what expenses may be deemed "legitimate" was its comment that "some expenses from petitioners' scheme went toward lease payments and cancer-treatment equipment," which "arguably have value independent of fueling a fraudulent scheme."[9]

*Liu's* holding that courts must take care to deduct "legitimate" expenses from fraud proceeds is a more restrictive approach to SEC disgorgement than most courts had previously taken. The *Liu* court noted that the 8th Circuit, in *SEC v. Brown*, 658 F.3d 858, 861 (8th Cir. 2011), had "declin[ed] to deduct even legitimate expenses like payments to innocent third-party employees and vendors."[10] Indeed, *Brown* and other courts had stated generally that "the overwhelming weight of authority hold[s] that securities law violators may not offset their disgorgement liability with business expenses."[11] Courts had, to be sure, permitted the deduction of certain limited direct transaction costs, such as brokerage commissions in the context of a securities trading fraud.[12] But they had also broadly rejected deducting any or all indirect expenses, such as overhead expenses—and had not sought to determine whether the overhead expense at issue was a legitimate business expense.[13]

Post-*Liu*, on the other hand, the lower courts will need to engage in a fact-specific inquiry as to what constitutes a "legitimate" versus an illegitimate expense for SEC disgorgement purposes. In particular, *Liu* left open how the courts should think about whether a portion of a defendant's overhead expenses should be deducted from proceeds in directing disgorgement.[14] No published opinion has yet sought to apply *Liu's* ruling as to what is a "legitimate" expense that should reduce the disgorgement amount.[15] But defendants should offer evidence that both direct and indirect expenses should be deducted from the gross proceeds of the claimed fraud—since the

9 *Id.* at 1941-1942.

10 *Id.* at 1950.

11 *SEC v. Brown*, 658 F.3d at 860-861 (quoting *SEC v. United Energy Partners, Inc.*, 88 Fed.Appx. 744, 746 (5th Cir. 2004); *SEC v. Kenton Capital*, Ltd., 69 F.Supp.2d 1, 16 (D.D.C.1998); *SEC v. Hughes Capital Corp.*, 917 F.Supp. 1080, 1087 (D.N.J.1996) (same), aff'd, 124 F.3d 449 (3d Cir.1997); *SEC v. Great Lakes Equities Co.*, G., 775 F.Supp. 211, 214 (E.D. Mich. 1991) ("The deductions for overhead, commissions and other expenses are not warranted. The manner in which defendants Sims and Great Lakes Equities Co. chose to spend their misappropriation is irrelevant as to their objection to disgorgement."); *SEC v. World Gambling Corp.*, 555 F.Supp 930, 935 (S.D.N.Y. 1983) ("The 'profit obtained' cannot be said to be a punitive standard for disgorgement, even though it may be slightly overstated by overhead and income taxes, and in any event that standard remains the proper measure for achieving restitution, which is itself a proper objective.").

12 *SEC v. Universal Exp., Inc.*, 646 F.Supp.2d 552, 564 (S.D.N.Y. 2009) ("Courts in this Circuit consistently hold that a court may, in its discretion, deduct from the disgorgement amount any direct transaction costs, such as brokerage commissions, that plainly reduce the wrongdoer's actual profit," *SEC v. McCaskey*, No. 98 Civ. 6153, 2002 WL 850001, at *4 (S.D.N.Y. Mar. 26, 2002), but they have taken care to distinguish such costs from "general business expenses, such as overhead expenses, which should not reduce the disgorgement amount." Id. n. 6).

13 *SEC v. Rosenfeld*, Case No. 97-CIV-1467, 2001 WL 118612, at *2 (S.D.N.Y. Jan. 9, 2001) ("A court may in its discretion, deduct from the defendant's gross profits certain expenses incurred while garnering the illegal profits, including correspondence and related expenses and transaction costs such as brokerage commissions. This, however, does not mean that a defendant can group his expenses under a broad category of business costs and accordingly expect deductions from the disgorgement amount without supporting evidence.") (internal citations omitted); *But see SEC v. Thomas James Assocs., Inc.*, 738 F.Supp. 88, 92 (W.D.N.Y 1990) ("I find that it is appropriate to offset [] gross profits. . .with certain business expenses attributable thereto. . .for example, commissions, telephone charges, underwriting expenses and a proportionate share of overhead.").

14 In other substantive areas, courts have permitted allocation of overhead to reduce damages awards. In copyright and trademark cases, for example, courts have long allowed allocation of overhead to reduce infringement damages under the applicable damages statute. But the cases' treatment of overhead is a creature of statute rather than derived from equitable principles, they are not directly relevant in securities fraud cases. See, *Sheldon v. Metro-Goldwyn Pictures Corp.*, 106 F.2d 45, 54 (2d Cir. 1939) (overhead should be allocated and deducted in measuring damages to the extent it reflects value added to the infringing production, "a question of fact in all cases."); *Supreme Sec. Sys., Inc. v. Supreme Sec. Servs., Inc.*, Case No. 08 CV 2084 (JG) (RML), 2012 WL 1078832 (E.D.N.Y. March 6, 2012) (defendant must demonstrate "what overhead expense categories (such as rent, business, entertainment, personnel and public relations) are actually implicated" by the wrongful conduct, so that it can be deducted from damages); *Gaste v. Kaiserman*, 863 F.2d 1061, 1069-71 (2d Cir. 1988) (jury permissibly found that only 8% of the infringer's costs were "attributable to the infringement" even though the infringing song at issue generated 90% of the company's revenue).

15 A Texas federal court recently held that a wrongdoer's salary derived from the fraud was disgorgeable net profit as to that wrongdoer, but did not consider whether any expenses were deductible. *SEC v. Faulkner*, Case No. 3:16-cv-1735-D, 2021 WL 75551 (N.D. Tex. Jan. 8. 2021) ("Funds that Hallam received as compensation for his role in the Faulkner Scheme clearly constitute "net profits" *as to Hallam*, the wrongdoer. Because Hallam has failed to present evidence of his *own* expenses, the court can only conclude that the entirety of these funds constituted Hallam's net profits. Under *Liu* disgorgement of these payments is clearly permitted.").

direct thrust of *Liu* is that disgorgement's purpose and effect is limited to return of proceeds that the wrongdoer has pocketed—not to return all of the fraud proceeds including amounts that might have been expended in carrying out the fraud.

We also note that in January 2021, the National Defense Authorization Act for Fiscal Year 2021 included an Exchange Act amendment that codified for the first time the SEC's authority to obtain disgorgement in federal court of any unjust enrichment by securities law violators. While the NDAA significantly limits the effect of *Kokesh* by extending the statute of limitations for disgorgement in scienter cases to 10 years, there is nothing in the new provision suggesting that it was intended to broaden the meaning of disgorgement beyond the equitable restrictions imposed by *Liu*.[16]

## III. Expenses through an accounting lens

To examine the possibilities of *Liu's* impact, accounting standards could assist courts in defining and identifying expenses that are "legitimate" versus "illegitimate." Expenses are notionally defined in accounting literature as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations."[17] Simply, expenses are incurred as a business utilizes resources to perform business activities—whether those activities are paying employee salaries, marketing costs, or other general and administrative items—they are defined by their (1) payment during a period and (2) use to further the aims of the business.

"Legitimacy" for purposes of considering disgorgement rests solely on the second factor above—did the expense further the aims of a "legitimate" facet of the business? For example, accountants routinely consider whether a company's car lease payment was made to lease a modest sedan for a salesperson required to travel full-time (a legitimate expense), or is the payment actually being made for the lease on a sports car for an executive with no real business purpose (presumably illegitimate)? The simplest examples appear straightforward, but in thinking about expense legitimacy and disgorgement, it is useful to consider several plausible fraud scenarios, spelled out below.

### Scenario 1 — Investment fraud involving all investor proceeds

A purported investment advisor solicits funds from accredited investors utilizing a "key-man" strategy, in which the investment advisor convinces investors he can beat the market based on his own personal insight and experience. The investment advisor receives $100,000 from 100 investors at $1,000 each. The investment advisor does not invest any of the $100,000 investment, but spends $99,000 on personal travel, luxury goods and personal purchases, and $1,000 on printing investment solicitation materials. Upon many denied redemption requests, the investment advisor is forced to admit the scheme and close the business.

*Amounts subject to disgorgement analysis = $100,000*

Scenario 1 is a relatively straight-forward example of a Ponzi scheme or other investment fraud. Due to the fact that the investment advisor never purchased equity shares on behalf of investors, the entire scheme would be viewed as illegitimate and any expenses incurred by the business would not be considered as legitimate expenses. One may argue that the $1,000 spent on marketing materials is an "outflow…carrying out…activities that constitute the entity's…operations," but *Liu* suggests that a court may not even have to deduct that expense: "when the 'entire profit of a business or undertaking' results from the wrongdoing, a defendant may be denied 'inequitable deductions' such as for personal services."

*Disgorgement amount = $100,000*

### Scenario 2 — Fraud involving a portion of investment proceeds

An established investment advisor creates a new investment fund for accredited investors utilizing a simple arbitrage strategy in which the advisor utilizes investor funds to purchase equity shares in blue-chip companies while also purchasing appropriate calls on those shares to hedge against undesired risk over a one-year period. The advisor receives $50,000 from 50 investors at $1,000 each. The investment advisor spends $45,000 to carry out the agreed-upon arbitrage strategy, and each investor recognizes a net gain of $250 at the end of the year, redeeming $1,250 each (for a total investor gain of $12,500). However, the advisor also diverts $5,000 of the

16 NDAA Section 6501; *see Liu* at 1947 (" 'statutory references' to a remedy grounded in equity 'must, absent other indication, be deemed to contain the limitations upon its availability that equity typically imposes.'"), *quoting Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 211, n.1.

17 Statement on Financial Accounting Concepts ("CON") No. 6 – Elements of Financial Statements, as amended 2008, at ¶80.

investment to trade in the arbitrage strategy on his own behalf, and, trading on margin, realizes a gain of $12,500 on the investment, and redeems $17,500 to a personally held account.

*Amounts subject to disgorgement analysis = $75,000 ($50,000 invested funds plus earnings of $25,000)*

Scenario 2 provides a more complex set of circumstances regarding disgorgement in that only a portion (10%) of investor funds was utilized in violation of the agreed-upon investment strategy. It may be straightforward to understand that the $45,000 invested, and the $12,500 returned to investors would constitute compliance with the investment management agreement, and would not be considered fraudulent or subject to disgorgement. As to the $5,000 utilized by the investment advisor and their gain of $12,500, though, all $17,500 would be subject to disgorgement without deduction as the costs incurred to perform the arbitrage strategy; the use of the funds was entirely illegitimate as outlined in the investment agreement (as was the transfer to a personal account for use by the investment advisor).

*Disgorgement amount = $17,500 ($5,000 investor funds taken illegitimately and $12,500 gain on trading on those illegitimate funds)*

### Scenario 3 — Fraud involving a portion of business, with common overhead

Our third scenario introduces the important element of overhead expense. A consumer products company domiciled in the United States with operations in the United States and Canada has been found to have violated applicable U.S. securities laws regarding its sales practices and related disclosures for its Canadian operations (which comprise one-third of global company sales). The product was sold in good faith, but an inherent design flaw was discovered late in the fiscal year, and it was not disclosed there would be a major recall in the following year. While all Canadian revenues were tainted by the misleading disclosures, the conduct of the U.S.-only sales operations is in full compliance with U.S. securities laws, and not subject to penalty or disgorgement. However, operations and back-office activities for the global company are centralized in the United States. The results of the Canadian operations that violated U.S. securities laws are shown in the table below:

| | |
|---|---|
| Sales | $35,000,000 |
| COGS | 10,000,000 |
| **Gross profit** | **25,000,000** |
| *Direct expenses* | |
| Payroll | 20,000,000 |
| Utilities | 500,000 |
| Property | 300,000 |
| **Direct expenses** | 20,800,000 |
| **Operating income** | **4,200,000** |
| Other gains | 1,000,000 |
| Interest expense | (200,000) |
| **Profit before shared overhead** | **$5,000,000** |

Viewed most aggressively, the fact that the entirety of the Canadian operations is deemed to be in violation of U.S. securities laws would appear to put any analysis of disgorgement amounts in the same category as Scenario 1, as all expenses incurred may be deemed illegitimate. Thus, it is conceivable that the SEC could argue that all Canadian revenue was subject to disgorgement. But since our scenario involves an otherwise-legitimate business whose U.S. revenue is unaffected by fraud, it is far more likely that all of the direct Canadian expenses would be deemed "legitimate" and deductible in determining disgorgement within the meaning of *Liu*. This would mean the entirety of the Canadian subsidiary's profits before shared overhead are open to disgorgement.

*Potential disgorgement amount = $5,000,000 (the entirety of the Canadian subsidiary's profits without deducting shared overhead)*

That leads to the more difficult question of whether the disgorgement amount should be reduced by shared overhead. This leads to an analysis of the appropriate allocation of costs shared between the U.S. sales operations (which are entirely legitimate) and the Canadian operations—as to which overhead might be deemed "illegitimate."

Due to the business's centralized operations, certain expenses incurred at the corporate entity level in the U.S. must be allocated to the Canadian operations for appropriate accounting treatment. Such costs, generally categorized as "overhead," for the global company are shown in the table below. Note that for the purposes of this example, we assume that none of these costs were directly implicated in the violation of U.S. securities laws in the Canadian operation, and in that respect, all are deemed legitimate:

| | |
|---|---|
| IT | $2,000,000 |
| Executive team | 8,000,000 |
| HR and benefits | 1,000,000 |
| General counsel | 1,000,000 |
| Customer support | 500,000 |
| Marketing | 2,000,000 |
| Accounting dept. | 500,000 |
| **Total overhead** | **$15,000,000** |

There is no single standard method of allocation of overhead. The accounting guidance for such treatment is principles-based, in that the method chosen by any individual company must be made in good faith and not in violation of any other accounting guidance that is more prescriptive. The standard practice is to allocate between companies based on the principle of cost causation or "cost-driver." Appropriate methods of overhead allocation are usually based on characteristics easily compared between operations, such as sales, payroll or headcount.

If overhead allocation at this entity is consistently applied using a percentage of sales method, the accounting treatment for the above overhead expenses would be to allocate $10 million to the U.S. operations and $5 million to the Canadian operation—since as noted above, Canada accounts for one-third of the company's sales. There is a strong argument that the required "deduction of legitimate expenses" language of *Liu* means that the $5 million in allocable overhead would be deducted from the potential total disgorgement amount, thus eliminating disgorgement altogether.

*Disgorgement amount = $0 ($5 million of "ill-gotten gains" less $5 million or one-third of legitimate overhead expenses allocated to the Canadian operation based on sales)*

Another consideration would be if certain overhead costs are allowed as "legitimate" and others are deemed "illegitimate" in that the expense is closely tied to the fraudulent Canadian sales. For this example, assume that half of the general counsel time in the period related to dealing with the falsified Canadian disclosure. This amount would be deemed in furtherance of the scheme, and presumably considered illegitimate. Similarly, assume that half of executive time, customer support, accounting department and marketing time during the period were also consumed with either supporting or addressing the fraudulent sales, and thus also arguably "illegitimate" for disgorgement purposes. This would change the total potential shared overhead reduction considerably.

| | Total shared overhead | Overhead deemed legitimate |
|---|---|---|
| IT | $2,000,000 | $2,000,000 |
| Executive team | 8,000,000 | 4,000,000 |
| HR and benefits | 1,000,000 | 1,000,000 |
| General counsel | 1,000,000 | 500,000 |
| Customer support | 500,000 | 250,000 |
| Marketing | 2,000,000 | 1,000,000 |
| Accounting dept. | 500,000 | 250,000 |
| **Total overhead** | **$15,000,000** | **$9,000,000** |

*Disgorgement amount = $2,000,000 ($5 million of "ill-gotten gains" less $3 million or one-third of legitimate overhead expenses allocated to the Canadian operation based on sales)*

## IV. Legal analysis

The earlier scenarios help illustrate the potential impacts of *Liu* in SEC disgorgement cases. A Ponzi scheme as depicted in Scenario 1 would elicit the same analysis pre– and post–*Liu*: where the entire enterprise was illegitimate, so were all of the expenses incurred. The second scenario is also fairly straightforward in that a segregable portion of the advisor's program was affected by fraud, and it is therefore relatively easy to allocate the portion of investment proceeds that should be disgorged.

But in the large number of cases involving fraud affecting only a portion of the defendant's business, the direction that *Liu* provides to the lower courts is far less clear. While *Liu* speaks in seemingly plain terms about limiting disgorgement to "net profit" after deducting "legitimate" expenses, those terms are anything but simple from an accounting or legal standpoint, and the courts will no doubt differ substantially in applying them.

As to overhead expenses, most courts pre–*Liu* categorically disallowed any deduction in determining disgorgement.[18] But *Liu* suggests that in cases where the securities fraud affects only part of the defendant's business operations, "legitimate" expenses could or should include allocable overhead. As in *Liu*, whether overhead expenses should be deducted may depend on whether the expenses "arguably have value independent of fueling a fraudulent scheme." *Liu*, 140 S. Ct. at 1950. Defendants in such cases can and should argue that the courts should approach allocation of overhead by arguing that a significant portion of a company's indirect expenses do have such "independent value."

It should also be noted that the recent Supreme Court rulings in *Kokesh* and *Liu* may influence the SEC's enforcement division to seek to rely more heavily on statutory penalties in cases where disgorgement may be curtailed by the effect of the two cases. (As an indicator of the division's relative use of disgorgement and penalties, in 2020, total disgorgement awards were approximately triple the total amounts of penalties imposed in commission actions and proceedings.)[19] Indeed, in its most recent annual report, the enforcement division noted that there "will continue to be changes in the balance between the penalties and disgorgement that the division seeks and recommends to the commission."[20] But the recent Exchange Act amendment in the NDAA lengthening the statute of limitations to 10 years in some cases may leave the SEC more optimistic that the courts will continue to award disgorgement in amounts that will enable it to satisfy at least most of its remedial goals.

## V. Conclusion

The *Liu* decision will provide an opportunity for defense counsel and forensic accountants to argue for meaningful reductions in disgorgement that must be limited to net profits. They will have significant arguments that appropriate overhead must be deducted in determining disgorgement.

18 *See* cases cite *supra* note 9.

19 The Division of Enforcement obtained $3.6 billion in disgorgement and $1.1 billion in penalties in actions and proceedings. *See* SEC Division of Enforcement, 2020 Annual Report, at 17.

20 *Id.* at 7.

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