NOTE

Equitable Remedies and Inequitable Deductions: Constructive Dividends and Disgorgement After *Liu*

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ABSTRACT

Disgorgement has been a powerful tool for the Securities and Exchange Commission ("SEC") to recover billions in ill-gotten gains from securities fraud defendants. In a series of recent cases culminating in Liu v. SEC*, the Supreme Court affirmed the SEC's ability to pursue disgorgement but limited the remedy to a defendant's net profits. Confusingly, the Court also mentioned a potential exception to the net profit limitation for "wholly fraudulent" schemes, in which deductions are denied for expenses connected entirely to the perpetration of the fraud. Congress later expressly authorized the SEC to pursue disgorgement in civil cases, raising the question of whether the equitable limits from* Liu *still apply to the new authority. In response, courts have offered competing analyses of what may be deducted when calculating the defendant's liability.*

This Note proposes using tax law's constructive dividend rule to clarify the "wholly fraudulent" scheme exception. A constructive dividend is when a claimed business expense is legally recognized as a taxable distribution of income, on the grounds that the expenditure only conferred a benefit to the recipient, not the business. Both constructive dividend and disgorgement cases require a focus on substance over form to determine who benefitted from a given transaction. While tax law and securities law have separate purposes, the constructive dividend doctrine offers clarity for a challenging analytical problem.

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Introduction

One of the most intuitive uses of equity is to compel an offender to give back what was wrongfully gained by a transgression. This remedy, often ordered in fraud cases, is known as "disgorgement."[1] The Securities and Exchange Commission ("SEC") has sought disgorgement in a wide array of enforcement actions to recover billions of dollars from fraud defendants.[2] In a series of recent cases culminating in *Liu v. SEC*,[3] the Supreme Court affirmed the SEC's ability to seek disgorgement in district court, limiting the remedy to the traditional bounds of equitable remedies.[4] These boundaries include limiting recovery to a defendant's net profits.[5] Confusingly, the opinion also endorsed a potential exception[6] to the net profit limitation for "wholly fraudulent" schemes, in which

1 Restatement (Third) of Restitution & Unjust Enrichment § 51(4) (Am. L. Inst. 2011).

2 Press Release, SEC, SEC Announces Enforcement Results for Fiscal Year 2023 (Nov. 14, 2023), https://www.sec.gov/news/press-releases/2023-234 [https://perma.cc/DP5K-ULR4].

3 591 U.S. 71 (2020); *see also* Kokesh v. SEC, 581 U.S. 455 (2017).

4 *Liu*, 591 U.S. at 91–92.

5 *See id.* at 87.

6 *See infra* Section II.B.

deductions are denied for expenses connected entirely to the perpetration of the fraud.[7] Congress subsequently amended the securities laws to expressly authorize the SEC to pursue disgorgement in civil cases, raising a question of whether the equitable limits outlined in *Liu v. SEC* still apply to this new, express statutory grant of authority.[8] In the wake of these questions, lower courts have offered competing analyses of what can and cannot be deducted in determining the defendant's liability.[9] With over $3.3 billion of disgorgement ordered in fiscal year 2023,[10] the amount of money hinging on what initially sounds like an obscure question can be staggering. Further, the recent Supreme Court ruling in *SEC v. Jarkesy*,[11] which found that a jury trial right exists for civil monetary penalties in fraud cases,[12] may leave equitable disgorgement as the most powerful remedy still available in administrative proceedings.[13]

Tax law's constructive dividend rule offers a way to clarify the wholly fraudulent scheme exception. A claimed business expense is considered a constructive dividend when it is legally recognized as a taxable distribution of income on the grounds that the expenditure conferred a benefit solely to the recipient, not the business.[14] For example, building a house on corporate land and permitting the owner to live there would be a constructive dividend to the owner, not a business expense.[15] When a dividend is found, the court denies the deduction and the recipient must then include it in personal taxable income.[16] This is similar to the "wholly fraudulent scheme" exception rationale, under which illegitimate distributions to oneself or one's accomplices are not deductible expenses.[17] In both analyses, the relevant question is whether the transaction at

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7 *Liu*, 591 U.S. at 92.

8 Theresa Titolo, Lorraine B. Echavarria, Matthew T. Martens, Lori A. Martin, Elizabeth L. Mitchell, Jaclyn Moyer, Nicole Rabner & Matthew Beville, *Congress Amends Exchange Act in Response to* Kokesh *and* Liu*, Expanding SEC Enforcement Power*, Inv. Lawyer, Apr. 2021, at 1, 3.

9 *See infra* notes 102–05 and accompanying text.

10 *See SEC, supra* note 2.

11 603 U.S. 109 (2024).

12 *See id.* at 140.

13 *See U.S. Supreme Court Limits Use of SEC Administrative Courts in Antifraud Actions*, Sidley Austin LLP (June 28, 2024), https://www.sidley.com/en/insights/newsupdates/2024/06/us-supreme-court-limits-use-of-sec-admin [https://perma.cc/77V2-UV3Z] (noting the SEC's ability to seek disgorgement and other remedies in administrative proceedings is "an open question").

14 *See* Ireland v. United States, 621 F.2d 731, 735 (5th Cir. 1980) ("In order for a company-provided benefit to be treated as income, the item must primarily benefit taxpayer's personal interests as opposed to the business interests of the corporation.").

15 *See, e.g.*, Crosby v. United States, 496 F.2d 1384, 1388–91 (5th Cir. 1974) (finding utilities paid by the corporation and rental value of corporate-owned house lived in by the owner could be a constructive dividend to the corporate owner).

16 *See generally* I.R.C. § 61(a) (definition of gross income).

17 *See* SEC v. Hughes Cap. Corp., 124 F.3d 449, 456 (3d Cir. 1997) (finding codefendant spouse liable for gains that funded her "lavish lifestyle").

issue is a true business expense or merely a disguised shifting of income to the perpetrator.[18] While tax law and securities law have separate and distinct purposes, the constructive dividend concept offers a solution to a confusing analytical problem. By using the constructive dividend rule to calculate disgorgement amounts, courts can adhere to *Liu*'s equitable limitations and navigate the fraudulent scheme exception.

Part I of this Note examines the evolution of civil disgorgement in securities enforcement suits and its relation to restitution and other equitable remedies. Part II outlines the existing doctrine of constructive dividends in federal income tax law, which recognizes a benefit taken from an entity as income to the recipient. Part III proposes applying the constructive dividend rule to the *Liu* fraud exception in disgorgement actions. This approach has the advantage of being grounded in economic analysis while staying within the bounds of both pre- and post-*Liu* disgorgement caselaw.

I. Disgorgement

With the merger of law and equity in the federal courts, "there is only one action—a 'civil action'—in which all claims may be joined and all remedies are available."[19] Different remedies, however, retain their legal or equitable character.[20] Disgorgement emerged from a line of restitution remedies based on equitable principles.[21] In *Great-West Life & Annuity Insurance Co. v. Knudson*,[22] the Supreme Court found that "whether [restitution] is legal or equitable depends on 'the basis for [the plaintiff's] claim' and the nature of the underlying remedies sought."[23] The test is whether a remedy was "*typically* available in equity."[24] Recent Supreme Court cases and congressional action, while

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18 *Compare* Sammons v. Comm'r, 472 F.2d 449, 451 (5th Cir. 1972) ("It is a well-established principle that a transfer of property from one corporation to another corporation may constitute a dividend to an individual who has an ownership interest in both corporations."), *with* SEC v. Camarco, No. 19-1486, 2021 WL 5985058, at *13–17 (10th Cir. Dec. 16, 2021) (securities fraud case determining remedy by calculating amount of ill-gotten benefits received by each defendant).

19 Ross v. Bernhard, 396 U.S. 531, 539 (1970).

20 *See id.* at 540 ("[L]egal and equitable issues may be handled in the same trial."); Chauffeurs, Local No. 391 v. Terry, 494 U.S. 558, 565 (1990) ("To determine whether a particular action will resolve legal rights, we examine both the nature of the issues involved and the remedy sought.").

21 *See* Liu v. SEC, 591 U.S. 71, 80 (2020) ("Decisions from this Court confirm that a remedy tethered to a wrongdoer's net unlawful profits, whatever the name, has been a mainstay of equity courts."); *see also Chauffeurs*, 494 U.S. at 570; Tull v. United States, 481 U.S. 412, 424 (1987).

22 534 U.S. 204 (2002).

23 *Id.* at 213 (second alteration in original) (quoting Reich v. Cont'l Cas. Co., 33 F.3d 754, 756 (7th Cir. 1994)). More recently, in determining the nature of the action for Seventh Amendment purposes, the Court looked to the remedy sought. *See* SEC v. Jarkesy, 603 U.S. 109, 122–23 (2024).

24 *Great-West Life & Annuity Ins. Co.*, 534 U.S. at 219 (quoting Mertens v. Hewitt Assocs., 508 U.S. 248, 256 (1993)); *see also id.* at 222 (Stevens, J., dissenting) (applying same test from *Mertens*); *id.* at 228 (Ginsburg, J., dissenting) (same).

acknowledging disgorgement's equitable character, have raised new questions about the boundaries of such remedies, including the limits of recovery that can be ordered.[25] This Part examines disgorgement's evolution as an equitable remedy in securities enforcement and the recent changes from the Supreme Court and Congress.

A. Disgorgement and Equitable Remedies

The return of profits to their rightful owner distinguishes disgorgement from a fine or other penalty, which are traditionally remedies at law.[26] The Supreme Court has long held that equitable principles require that deductions be made from any recovery of ill-gotten gains for expenses incurred.[27] Disgorgement as an equitable remedy in the United States emerged from intellectual property infringement cases in which defendants were ordered to pay the patent holder what they had gained through the unauthorized use of the original work.[28]

In *Rubber Co. v. Goodyear*,[29] the Court held that equitable restitution should be awarded in the amount of the defendant's net profits and that excessive salaries should not be included in the deductions.[30] When determining the proper calculation of the award, "'[p]rofit' is the gain made upon any business or investment, when both the receipts and payments are taken into the account."[31] These deductible payments included "usual salaries of the managing officers."[32] However, the Court also identified an exception to deductibility: "extraordinary salaries which . . . were dividends of profit under another name, and put in that guise for concealment and delusion."[33] In equity, restitution was limited to net profits, but defendants were not allowed to deduct excessive

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25 Theresa A. Gabaldon, *Equity, Punishment, and the Company You Keep: Discerning a Disgorgement Remedy Under the Federal Securities Laws*, 105 CORNELL L. REV. 1611, 1655 (2020) ("If disgorgement is to be justified as an equitable remedy, it must be the type of relief typically available in equity.").

26 *Liu*, 591 U.S. at 79 ("[T]o avoid transforming an equitable remedy into a punitive sanction, courts restricted the remedy to an individual wrongdoer's net profits to be awarded for victims."); *see also* Bangor Punta Operations Inc. v. Bangor & Aroostook R.R. Co., 417 U.S. 703, 717 n.14 ("It is not the function of courts of equity to administer punishment." (quoting Home Fire Ins. Co. v. Barber, 93 N.W. 1024, 1035 (Neb. 1903))).

27 *See, e.g.*, Tilghman v. Proctor, 125 U.S. 136, 145–46 (1888) ("[I]t is inconsistent with the ordinary principles and practice of courts of chancery, either, on the one hand, to permit the wrongdoer to profit by his own wrong, or, on the other hand, to make no allowance for the cost and expense of conducting his business, or to undertake to punish him by obliging him to pay more than a fair compensation to the person wronged.").

28 *Liu*, 591 U.S. at 81.

29 76 U.S. (9 Wall.) 788 (1869).

30 *Id.* at 801–03.

31 *Id.* at 804, *quoted in Liu*, 591 U.S. at 83.

32 *Goodyear*, 76 U.S. (9 Wall.) at 803.

33 *Id.*

compensation to themselves—what the Court deemed "dividends"—as business expenses.[34]

The Court later reasoned in *Root v. Railway Co.*[35] that deductions wholly tainted by misconduct should not be deductible from restitution in what would become known as the "fraudulent scheme" exception.[36] "[W]hen the entire profit of a business or undertaking results from the use of the invention . . . the defendant will not be allowed to diminish the show of profits by putting in unconscionable claims for personal services or other inequitable deductions."[37] Here, the Court extended the logic of "dividends . . . under another name"[38] to deem an entire undertaking as fraudulent, for which no "unconscionable" deductions could reduce the amount to be disgorged.[39] The lack of clarity on what precisely made a deduction "unconscionable" raised the question of whether any deductions at all could be allowed from a wholly fraudulent scheme.

That question was addressed in *Callaghan v. Myers*,[40] in which the Court distinguished allowable and unallowable, illegitimate deductions in restitution. The defendant was allowed to deduct the "actual and legitimate manufacturing cost" of manufacturing the infringing books from the amount he owed.[41] However, the Court did not allow deductions for amounts the defendants who were partners in the infringing venture had paid other partners for their time:

> We do not think that the value of the time of an infringer, or the expense of the living of himself or his family, while he is engaged in violating the rights of the plaintiff, is to be allowed to him as a credit, and thus the plaintiff be compelled to pay the defendant for his time and expenses while engaged in infringing the copyright.[42]

The Court went on to expressly draw a line between nondeductible disbursements to a defendant and the deductible, usual salaries expenses in *Goodyear*.[43] The Third Restatement describes nondeductible, illegitimate expenses as "expenditures incurred directly in the commission of a wrong to the claimant."[44]

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34 *See id.* at 803–04.

35 105 U.S. 189 (1881).

36 *Liu*, 591 U.S. at 92 (citing *Root*, 105 U.S. at 203).

37 *Root*, 105 U.S. at 203. *Liu* also cites this proposition. 591 U.S. at 84.

38 *Goodyear*, 76 U.S. (9 Wall.) at 803.

39 *Root*, 105 U.S. at 203.

40 128 U.S. 617 (1888).

41 *Id.* at 665.

42 *Id.* at 664. *Liu* also cites this proposition. 591 U.S. at 84.

43 *Callaghan*, 128 U.S. at 664 (citing *Goodyear*, 76 U.S. at 803).

44 RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 51(5)(c) (AM. L. INST. 2011).

Further refining the calculation of unlawful gains, the Court in *Sheldon v. Metro-Goldwyn Pictures Corp.*[45] limited recovery by apportioning the amount attributable to the wrongdoing and deducting costs to arrive at net profits.[46] Film studio Metro-Goldwyn intentionally plagiarized a script by playwright Edward Sheldon for their 1932 film *Letty Lynton*.[47] Sheldon sued the studio for copyright infringement and sought all of Metro-Goldwyn's profits from the movie.[48] The Court declined to award Sheldon all of the studio's profits, reasoning "[t]hat would be not to do equity but to inflict an unauthorized penalty."[49] Instead, the Court apportioned the recovery, awarding Sheldon a recovery in proportion to the amount of the screenplay that was plagiarized and allowing Metro-Goldwyn to keep the proceeds from their original portion of the movie.[50] The remedy was limited to the unjust enrichment actually gained by the infringer due to wrongdoing.[51] However, as the Court noted, the mechanics of the apportionment calculation can be a difficult and fact-based exercise.[52]

Courts face an often-challenging task in unwinding complex financial transactions to calculate the proper amount of disgorgement.[53] Established caselaw recognizes the inherent difficulties in this inquiry and does not require courts to arrive at a precise figure. In 1989, the D.C. Circuit observed that "[r]ules for calculating disgorgement must recognize that separating legal from illegal profits exactly may at times be a near-impossible task. Accordingly, disgorgement need only be a reasonable approximation of profits causally connected to the violation."[54] The circuit courts uniformly applied this standard in subsequent enforcement suits,[55] and they have continued to do so in the wake of the changes from *Liu* restricting disgorgement.[56] Under the reasonable

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45 309 U.S. 390 (1940).

46 *Id.* at 405–06.

47 *Id.* at 396–97.

48 *See id.* at 396–98.

49 *Id.* at 405.

50 *See id.* at 408–09.

51 *Id.*

52 *See id.*

53 *See, e.g.*, SEC v. Hallam, 42 F.4th 316, 319–20 (5th Cir. 2022) (forensic accounting firm engaged to calculate disbursements defendant received from fraud); Complaint at 5–6, SEC v. Agridime LLC, No. 4-23CV-1224P (N.D. Tex. Dec. 11, 2023) (alleging victims' funds in a cattle Ponzi scheme were diverted from investing in "specific, identifiable animals" to making Ponzi payments to other defrauded investors).

54 SEC. v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989) (citation omitted).

55 *See Hallam*, 42 F.4th at 329.

56 *See, e.g.*, SEC v. Voight, No. 21-20511, 2023 WL 1778178, at *1 (5th Cir. Feb. 6, 2023) (applying the reasonable approximation standard after both *Liu* and the 2021 NDAA Amendments to the Exchange Act); SEC v. de Maison, Nos. 18-2564, 21-620, 2021 WL 5936385, at *2 (2d Cir. Dec. 16, 2021) (reaffirming reasonable approximation principles after *Liu*).

approximation standard, the SEC must first calculate the amount of unlawful proceeds the defendant accrued.[57] It is then up to the defendant to rebut the calculation by showing error or evidence of costs to be deducted.[58] In turn, the SEC may challenge those costs as nondeductible.[59] This burden shifting conforms to general equitable practice for disgorgement and restitution.[60] One motivating principle for applying a reasonable approximation standard in cases of complex financial fraud is that the risk of uncertainty in determining the amount of unjust gains lies with the wrongdoer.[61] As the Court noted in *Bigelow v. RKO Radio Pictures, Inc.*,[62] "[a]ny other rule would enable the wrongdoer to profit by his wrongdoing at the expense of his victim. It would be an inducement to make wrongdoing so effective and complete in every case as to preclude any recovery, by rendering the measure of damages uncertain."[63] This rule has been applied uniformly in SEC disgorgement cases, as courts do not give the benefit of the doubt to defendants whose wrongdoing has caused difficulties in calculation.[64] Courts are particularly likely to make defendants bear the risk of uncertainty when their commingling of assets makes a definitive accounting untenable.[65]

An additional implication of the reasonable approximation method is that specific tracing of assets is not required.[66] This is a benefit to

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57 *See First City Fin. Corp.*, 890 F.2d at 1232.

58 *See id.*

59 *See id.*; SEC v. Spartan Sec. Grp., 620 F. Supp. 3d 1207, 1226 (M.D. Fla. 2022), *appeal filed*, No. 22-13129 (11th Cir. Sept. 16, 2022) (considering but ultimately rejecting evidence presented by the SEC that some of the defendant's purported expenses were nondeductible).

60 *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT, § 51 cmt. i (AM. L. INST. 2011).

61 *See* Westinghouse Elec. & Mfg. Co. v. Wagner Elec. & Mfg. Co., 225 U.S. 604, 621–22 (1912).

62 327 U.S. 251 (1946).

63 *Id.* at 264–65 (holding that the wrongdoer is responsible for any uncertainty in calculating damages and should bear the resulting risk).

64 *See* SEC. v. First City Fin. Corp., 890 F.2d 1215, 1232 (D.C. Cir. 1989) (citing *Bigelow*, 327 U.S. at 265); *Spartan Sec. Grp.*, 620 F. Supp. 3d at 1225 ("Exactitude is not a requirement; so long as the measure of disgorgement is reasonable, any risk of uncertainty should fall on the wrongdoer whose illegal conduct created that uncertainty." (quoting SEC v. Calvo, 378 F.3d 1211, 1217 (11th Cir. 2004))).

65 Sheldon v. Metro-Goldwyn Pictures Corp., 309 U.S. 390, 406 (1940) ("Where there is a commingling of gains, he must abide the consequences, unless he can make a separation of the profits so as to assure to the injured party all that justly belongs to him."); *see also* SEC v. Goulding, 40 F.4th 558, 561–62 (7th Cir. 2022) (denying deductions from disgorgement amount when "[t]he magistrate judge found that Goulding used this account as his 'personal piggy bank' and paid all sorts of expenses from it, without regard to his legal entitlements").

66 FTC v. Bronson Partners, LLC, 654 F.3d 359, 374 (2d Cir. 2011) ("[T]he Federal Reporter is replete with instances in which judges of this Court deeply familiar with equity practice have permitted the SEC to obtain disgorgement without any mention of tracing."); *see also* SEC v. de Maison, Nos. 18-2564, 21-260, 2021 WL 5936385, at *2 (2d Cir. Dec. 16, 2021) (post-*Liu* case applying same standard).

enforcement agencies, foreclosing a potential challenge by defendants. Some defendants have argued that, as an equitable remedy, disgorgement could only compel the return of specific identifiable funds by the defendant.[67] Courts, however, have reasoned that money in a defendant's possession is fungible and that a reasonable approximation of net profits is enough evidence to order disgorgement of a defendant's gains.[68]

B. Liu *and Disgorgement in SEC Enforcement Actions*

Over the past fifty years, the SEC has frequently used disgorgement of the monies earned in a fraudulent scheme as a remedy in its civil enforcement suits.[69] Federal courts have exclusive jurisdiction over violations of the Securities Exchange Act of 1934 ("Exchange Act").[70] The SEC currently has the option to seek disgorgement as a remedy in either federal district court[71] or its own administrative proceedings.[72] As sought by the SEC, "[d]isgorgement is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws."[73]

Defendants and the SEC have clashed over whether disgorgement sought in district court by the SEC for violations of the Exchange Act is a civil penalty or an equitable remedy.[74] In *Kokesh v. SEC*,[75] the

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67 *See, e.g.*, SEC v. Camarco, No. 19-1486, 2021 WL 5985058, at *13–14 (10th Cir. Dec. 16, 2021); *see also* Liu v. SEC, 591 U.S. 71, 98 (2020) (Thomas, J., dissenting) ("[T]he traditional remedy of a constructive trust or an equitable lien requires that the 'money or property identified as belonging in good conscience to the plaintiff . . . clearly be traced to particular funds or property in the defendant's possession.'" (quoting Great-West Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204, 213 (2002))).

68 *See de Maison*, 2021 WL 5936385, at *1–2; *Camarco*, 2021 WL 5985058, at *15; *Bronson Partners*, 654 F.3d at 374.

69 *See* SEC v. Tex. Gulf Sulphur Co., 446 F.2d 1301, 1308 (2d Cir. 1971) (finding that the requirement of restitution was a proper use of the district court's equity powers); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) (holding that the Securities Act of 1933 and the Securities Exchange Act of 1934 confer equity powers on the federal district courts for purposes of ordering disgorgement), *abrogated in part by* Liu v. SEC, 591 U.S. 71 (2020).

70 15 U.S.C. §§ 78a–78rr; *see id.* § 78aa(a) ("The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder."); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Manning, 578 U.S. 374, 393 (2016) (holding that the Exchange Act's test for federal jurisdiction is the same as that for the general federal question jurisdiction statute, 28 U.S.C. § 1331).

71 15 U.S.C. § 78u(e).

72 *Id.* § 78u-3(e).

73 SEC v. First City Fin. Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989).

74 *See generally* Russell G. Ryan, *The Equity Façade of SEC Disgorgement*, Harv. Bus. L. Rev. Online (Nov. 15, 2013), https://journals.law.harvard.edu/hblr/2013/11/the-equity-facade-of-sec-disgorgement/ [https://perma.cc/D6H4-SCDQ] (comparing pre-*Liu* SEC disgorgement cases to the remedies of restitution at law and restitution at equity).

75 581 U.S. 455 (2017).

Supreme Court found that disgorgement, as sought by the SEC, was a penalty for purposes of the statute of limitations due to its punitive, rather than compensatory, nature.[76] This, in turn, raised the question of whether the SEC had authority to seek the remedy at all, given its reliance on the Exchange Act's authorization of "any equitable relief that may be appropriate or necessary for the benefit of investors."[77]

In *Liu*, the Court allowed the SEC to continue to seek disgorgement but found that the district court had imposed an equitable remedy and, thus, limited recovery to the net profit of the scheme based on the boundaries of equitable remedies.[78] Defendants Charles C. Liu and Xin Wang, husband and wife, collected money from investors claiming that it would be used to build and operate a cancer treatment facility in California.[79] The treatment center remained unbuilt after more than fifty Chinese investors gave money in hopes of participating in a special immigrant investor visa program.[80] Instead, the defendants diverted millions to personal accounts and firms in China with which they were affiliated.[81] The SEC brought a civil enforcement suit in district court seeking, inter alia, disgorgement of "all funds received from their illegal conduct."[82] The district court awarded disgorgement for the gross gain from the scheme.[83] After the Ninth Circuit affirmed on appeal,[84] the defendants appealed to the Supreme Court, arguing that the *Kokesh* holding and general equitable principles precluded the Commission from ordering disgorgement in excess of their net profits.[85]

Citing *Great-West*, the Court examined the characteristics of restitution remedies traditionally available at equity and found that disgorgement should be limited to the defendants' net profits from the fraud.[86] Drawing on a series of patent cases from the nineteenth century, the Court found that "to avoid transforming an equitable remedy into a punitive sanction, courts restricted the remedy to an individual wrongdoer's net profits to be awarded for victims."[87] This net profit limitation on the amount a defendant must disgorge allows them to deduct their costs from their total gains from a scheme.

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76 *Id.* at 465.

77 15 U.S.C. § 78u(d)(5).

78 Liu v. SEC, 591 U.S. 71, 77 (2020) ("[E]quity never 'lends its aid to enforce a forfeiture or penalty.'" (quoting Marshall v. Vicksburg, 82 U.S. (15 Wall.) 146, 149 (1872))).

79 Complaint at 2–3, SEC v. Liu, 262 F. Supp. 3d 957 (C.D. Cal. 2017) (No. 16-cv-00974), *vacated and remanded*, 591 U.S. 71 (2020).

80 *Id.* at 3.

81 *Id.*

82 *Id.* at 27.

83 *Liu*, 262 F. Supp. 3d at 975–76.

84 SEC v. Liu, 754 F. App'x 505, 508 (9th Cir. 2018), *vacated and remanded*, 591 U.S. 71 (2020).

85 *Liu*, 591 U.S. at 85.

86 *Id.* at 78–79.

87 *Id.* at 79.

However, the Court acknowledged a fraud exception to the deduction rule, citing both *Root* and *Goodyear*:

> It is true that 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. But that exception requires ascertaining whether expenses are legitimate or whether they are merely wrongful gains "under another name." Doing so will ensure that any disgorgement award falls within the limits of equity practice while preventing defendants from profiting from their own wrong.[88]

This "fraudulent scheme" exception, if broadly applied to eliminate deductions from the disgorged amount, could leave defendants exposed to liability exceeding the amount they gained from the scheme.[89] The Court declared that "it is not necessary to set forth more guidance addressing the various circumstances where a defendant's expenses might be considered wholly fraudulent," but it noted that the defendants' expenses for "lease payments and cancer-treatment equipment . . . arguably have value independent of fueling a fraudulent scheme."[90] The Court remanded the case to determine the disgorgement amount "consistent with the equitable principles underlying § 78u(d)(5)" of the Exchange Act.[91]

On remand, the district court encountered significant difficulty in applying the Supreme Court's instructions. Both the SEC and the defendants relied on unaudited financial statements from the business's external accounting firm, which had disclaimed any reliance on the numbers.[92] In effect, the parties and the court had to rely on the defendants' own statements in unwinding the fraud.[93] As might be expected in dealing with the aftermath of a massive financial scheme, this did not inspire the confidence of the district court.[94] "In conducting this difficult task, and taking heed of the Supreme Court's admonitions,

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88 *Id.* at 92 (citations omitted).

89 *Id.* at 91–92 ("Accordingly, courts must deduct legitimate expenses before ordering disgorgement under § 78u(d)(5). A rule to the contrary that 'make[s] no allowance for the cost and expense of conducting [a] business' would be 'inconsistent with the ordinary principles and practice of courts of chancery.'" (quoting Tilghman v. Proctor, 125 U.S. 136, 145–46 (1888)) (alterations in original)).

90 *Id.* at 92.

91 *Id.*

92 *See* SEC v. Liu, No. SACV 16-00974, 2021 WL 2374248, at *5 (C.D. Cal. June 7, 2021), *aff'd*, No. 21-56090, 2022 WL 3645063 (9th Cir. Aug. 24, 2022).

93 *See id.*

94 *Id.* ("The Court is left, then, with a general ledger prepared primarily on the say-so of an adjudicated fraudster, which the preparing accountant expressly stated could not be relied upon to detect errors or fraud, and parties and experts who did exactly that—relied on the ledger assuming its accuracy in order to determine what expenses were legitimate and what expenses were not.").

the Court [chose] to take a very liberal approach, arguably unduly favorable to Liu and Wang, as to what constitutes a legitimate expense."[95] The district court, "out of an abundance of caution," allowed deductions for the entirety of administrative fees paid to a firm that even defendant Liu described as "[his] wife's company."[96] The court begrudgingly allowed rental expenses for the purported treatment center site as legitimate expenses.[97] Taking a stricter tack, the court denied deductions for a purchase of a piece of medical equipment from a legitimate vendor, reasoning that the purchase was contrary to the terms of the offering memorandum and the motivation was to cut out another member of the project.[98] Finally, the court refused to "deduct one penny of the exorbitant salaries that Liu and Wang paid themselves for perpetrating their fraud on investors."[99] Faced with unreliable evidence and competing instructions from the Supreme Court—the net profits and fraudulent scheme language—the district court resorted to inferences about the character of transactions and often deferred to defendant's characterizations.

Following *Liu*, Congress amended the Exchange Act with the National Defense Authorization Act of 2021 ("NDAA")[100] to expressly authorize the SEC to seek disgorgement of monies earned in securities frauds.[101] Circuit courts are split on the issue of whether Congress intended to codify the equitable limits in *Liu* or to give the SEC broader authority with a new remedy at law, thereby abrogating *Liu*'s equitable limits.[102] The related issue—the difficulty measuring the net profit of the scheme—remains with either approach, as even disgorgement at law has been held to be net profits, not gross.[103] Some jurisdictions

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95 *Id.*

96 *Id.* at *6 (quoting SEC v. Liu, 262 F. Supp. 3d 957, 962 (C.D. Cal. 2017)).

97 *Id.* at *7.

98 *Id.* at *7–8.

99 *Id.* at *8.

100 William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 (NDAA), Pub. L. No. 116-283, 134 Stat. 3388.

101 *Id.* § 6501, 134 Stat. at 4625–26 (codified at 15 U.S.C. § 78u(d)(7)–(8)); *id.* § 6501(a)(1)(B), (a)(3) ("In any action or proceeding brought by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may order, disgorgement.").

102 *Compare* SEC v. Hallam, 42 F.4th 316, 334–41 (5th Cir. 2022) (finding the NDAA authorized a legal remedy of disgorgement grounded in pre-*Liu* precedent), *with* SEC v. Ahmed, 72 F.4th 379, 395 n.7 (2d Cir. 2023) (finding the NDAA merely codified *Liu*'s equitable limits, expressly disagreeing with *Hallam*). *See also* Jason R. Chohonis, Comment, *Patching the Holes in SOX: FCPA Disgorgement After* Liu *and the NDAA*, 71 Emory L.J. 841, 879 (2022).

103 *See, e.g.*, *Hallam*, 42 F.4th at 343; Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb, Inc., 734 F. Supp. 1071, 1077 (S.D.N.Y. 1990) ("To require disgorgement of all fees and commissions without permitting a reduction for associate expenses and costs constitutes a penalty assessment and goes beyond the restitutionary purpose of the disgorgement doctrine."); *see also* Andrew N. Vollmer, Liu *and the New SEC Disgorgement Statute*, 15 Wm. & Mary Bus. L. Rev. 307, 364–66 (2024) ("[Deduction of legitimate expenses] is an instance in which general disgorgement law overlaps

deduct some of the defendant's cost of running a fraudulent operation, while others have declined to do so in some cases, finding any deduction inappropriate when the entire operation was tainted by fraudulent conduct.[104] Any exclusion of fraudulent deductions risks exceeding the bounds of equity and transforming disgorgement into a penalty, as the defendant will be left in a worse position than before the fraudulent conduct occurred.

Most recently, district courts have struggled to tread the line between applying the *Liu* fraud exception narrowly enough to preserve its equitable character and ordering a purported disgorgement of gross proceeds that is, in fact, a penalty. Some courts have not allowed any deductions of the defendant's expenses in fraudulent schemes, raising concerns of exceeding the equitable limits of the disgorgement remedy.[105] Conversely, some commentators speculated that the equitable limitations of *Liu* could significantly hamper disgorgement as a robust enforcement mechanism for the SEC.[106] In fiscal year 2023, the amount ordered in disgorgement reached $3.37 billion, nearly rebounding to the high of $3.58 billion in 2020, the year *Liu* was decided.[107] Determining the dimensions of disgorgement will have large financial consequences for both the SEC and defendants.

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with and includes one of the *Liu* equitable limitations."); Brief of Remedies and Restitution Scholars as Amici Curiae in Support of Neither Side at 9, 11, Liu v. SEC, 591 U.S. 71 (2020) (No. 18-1501).

104 *See, e.g.*, *Ahmed*, 72 F.4th at 396–97 (declining to deduct profits made from transactions involving fraudulent conflicts of interest by the defendant); SEC v. Fisher, No. 21-60624, 2022 WL 13650848, at *4 (S.D. Fla. Oct. 21, 2022) (declining to deduct "general business and administrative expenses" on the basis that they contributed to generating fraudulent commissions); SEC v. O'Rourke, No. 19-CV-4137, 2020 WL 6565125, at *4 (E.D.N.Y. Nov. 9, 2020) (deducting costs of commissions to fraudulent coconspirators not before the court, on the basis that equitable remedies should not be punitive).

105 *See, e.g.*, SEC v. Russell, No. 22-55093, 2023 WL 4946603, at *2 (9th Cir. Aug. 3, 2023); SEC v. Goulding, 40 F.4th 558, 562 (7th Cir. 2022); *see also* Elisha J. Kobre, *Three Years After* Liu v. SEC*, Disgorgement Is Still a Potent Remedy for the SEC*, Reuters (June 8, 2023, 12:49 PM), https://www.reuters.com/legal/legalindustry/three-years-after-liu-v-sec-disgorgement-is-still-potent-remedy-sec-2023-06-08/ [https://perma.cc/29FY-UVNL] ("[I]t is clear that the decision has had no real significant effect on disgorgement awards.").

106 *See* Theresa Gabaldon, *The Insidious Effect of Soundbites: Why Fences Aren't Punishment*, 72 Am. U. L. Rev. 1, 11 (2022) ("If, under *Kokesh*, deterrence is punitive and, under *Liu*, equity cannot punish, then what is to become of injunctive relief?"); Cameron K. Hood, Note, *Finding the Boundaries of Equitable Disgorgement*, 75 Vand. L. Rev. 1307 (2022) (examining the new limitations on disgorgement following *Liu* and the NDAA amendments to the Exchange Act); David Levintow, *Down, but Not Out: After* Liu*, Disgorgement Challenges for the SEC in FCPA Enforcement*, 28 PIABA Bar J. 179, 195–99 (2021) (predicting that *Liu* will refine, but not entirely preclude, the SEC's seeking of disgorgement in most cases); Chohonis, *supra* note 102, at 844 ("[T]he Supreme Court has threatened the viability of disgorgement as an SEC enforcement action in the recent decisions of *Kokesh* and *Liu*.").

107 *See* SEC, *supra* note 2.

II. Constructive Dividends

Although tax law is generally separate from securities law, the concept of constructive dividends can be valuable in implementing the fraudulent scheme exception in accordance with *Liu*. Courts invoke the constructive dividend doctrine in tax law to prevent business owners from disguising distributions from their business as expenses.[108] This Part examines the scope and underlying logic of the constructive dividends rule.[109]

A. Dividends in the Income Tax Context

The Internal Revenue Code broadly requires most sources of income to be recognized for taxation.[110] Dividends, the distribution of property from a corporation to its owner, are one such source.[111] The United States employs a "classical system" of taxation, levying income taxes on both individuals and business entities.[112] Dividends are generally taxed once as income to the corporation and again as income to the recipient.[113] To avoid the resulting "double taxation," some business owners attempt to extract money from a corporation under the guise of a necessary business expense, which is tax deductible.[114] To prevent such subterfuge, courts will find such a distribution to be a "constructive dividend."[115]

Conversely, business expenses recognized as deductible under the Internal Revenue Code reduce taxable income,[116] which, in turn, usually reduce a corporation's tax liability. The Code excludes some items,

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108 *See* Robert L. Hines, *Constructive Dividends—Ever-Present Threat*, 50 A.B.A. J. 684, 684 (1964).

109 This Note does not address whether amounts paid in disgorgement are themselves tax deductible nor whether they are taxable income to the recipient. *See* Ziroli v. Comm'r, 124 T.C.M. (CCH) 62084 (2022) (denying deduction for payment of disgorgement).

110 *See* I.R.C. § 61(a).

111 *See id.* § 61(a)(7).

112 Christopher H. Hanna, *Corporate Tax Integration: Past, Present, and Future*, 75 Tax Law. 307, 312 (2022).

113 *See id.*; *see also* I.R.C. § 11(a) (imposing a tax "for each taxable year on the taxable income of every corporation"); *Forming a Corporation*, Internal Revenue Serv. (Sept. 30, 2024), https://www.irs.gov/businesses/small-businesses-self-employed/forming-a-corporation [https://perma.cc/3ZVV-QGT6] ("The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. This creates a double tax.").

114 *See* Hines, *supra* note 108, at 684 (examining the viability of tax avoidance strategies for closely held corporations in light of the constructive dividend rule).

115 *See id.*

116 I.R.C. § 162(a) ("There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .").

such as bribes,[117] lobbying expenses,[118] and fines,[119] from deductibility.[120] Because of the statutory exclusions, the categorization of transactions can have an impact on the corporation's tax burden and financial performance.

Despite the term "dividend," the constructive dividend doctrine applies in the absence of any formalities commonly associated with declared dividends.[121] A constructive dividend does not need to be in the form of cash,[122] and the taxpayer need not have actually received any money directly.[123] The Tax Court notes that "[a] constructive dividend can take the form of either a distribution of corporate funds, the use of corporate property for personal purposes, or paying off a personal expense of the shareholder by the corporation."[124] These broad categories encompass a wide range of transactions, including excessive compensation, inflated rents and royalties, sale and leaseback arrangements, "bargain sales" to owners, inflated sale prices paid by the corporation, bargain use of corporate property, loans to owners, and inflated interest payments to owners.[125] Regardless of the particular form, constructive dividends result in a benefit to the owner instead of the business.

B. Application: Finding Transactions to Be Dividends

Transactions that ostensibly serve a business purpose but are motivated to enrich the stockholder pose an additional layer of

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117 *Id.* § 162(c).

118 *Id.* § 162(e).

119 *Id.* § 162(f).

120 *See* Douglas A. Kahn & Howard Bromberg, *Provisions Denying a Deduction for Illegal Expenses and Expenses of an Illegal Business Should Be Repealed*, 18 Fla. L. Rev. 207, 210–12 (2016) (discussing the statutory exclusions' relationship with the common law "frustration of public policy doctrine").

121 Paramount-Richards Theatres v. Comm'r, 153 F.2d 602, 604 (5th Cir. 1946) ("Corporate earnings may constitute a dividend notwithstanding that the formalities of a dividend declaration are not observed; that the distribution is not recorded on the corporate books as such; that it is not in proportion to stockholdings, or even that some of the stockholders do not participate in its benefits.").

122 *See* Treas. Reg. § 1.317-1 (1960) (defining "property" in the context of a corporate distribution).

123 *See* Helvering v. Horst, 311 U.S. 112, 118 (1940) ("The power to dispose of income is the equivalent of ownership of it."); Note, *Constructive Dividends: Taxing the Waiving Shareholder to the Extent of Dividends Waived*, 1966 Duke L. J. 801, 801.

124 Gow v. Comm'r, 79 T.C.M. (CCH) 1680, 1692 (2000), *aff'd per curiam*, 19 Fed. App'x. 90 (4th Cir. 2001) (finding that expenses related to the procurement of hunting trophies and vacations were a benefit to the owner, not the corporation, and thus a constructive dividend).

125 *See generally* Maynard J. Toll, *Constructive Dividends*, 3 Proc. Tax Inst. 211 (1951) (examples of transactions that constitute constructive dividends).

complexity in the constructive dividend analysis, but courts and regulations have established a method of inquiry to identify such constructive dividends. In general, what would otherwise be a legitimate business transaction can constitute a dividend if it is conducted at terms other than an arm's length basis, i.e., economically benefitting the shareholder more than a deal would benefit a hypothetical third party.[126] The determinative character of a constructive dividend is that "the corporation conferred an economic benefit on the stockholder without expectation of repayment."[127] This offers a standard grounded in economic analysis for whether a recipient has a constructive dividend rather than a subjective inquiry into the underlying motivations for a given transaction.[128]

The consequences of finding a constructive dividend are twofold.[129] First, the business entity is not allowed to deduct the expense on its corporate taxes.[130] Second, the recipient must include the dividend in their own personal income.[131] These dual consequences reflect the underlying economic rationale for the recognition of income. In finding a transaction to be a constructive dividend, the court looks past the ostensible form of a transaction and instead relies on the actual flow of benefits between a corporation and its owners.[132] This approach is part of a long-standing doctrine in tax law known as "substance over form."[133] The constructive dividend doctrine allows courts to make findings of fact based on the economic substance of a transaction.[134] These economic determinations are particularly well-suited for heavily fact-based inquiries such as securities fraud.

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126 *See* Treas. Reg. § 1.301-1(h) ("If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, such shareholder is treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution is the excess of the fair market value of the property over the amount paid for such property at the time of the transfer."); *see also* Toll, *supra* note 125, at 236–37 (discussing application of doctrine to corporate transactions).

127 United States v. Smith, 418 F.2d 589, 593 (5th Cir. 1969).

128 The "expectation of repayment" is evaluated under an objective, "reasonable expectations" standard. *See generally* Peter C. Canellos, *Reasonable Expectations and the Taxation of Contingencies*, 50 Tax Law. 299, 315 (1997) ("Whether debt is true debt outside the stock vs. debt area likewise turns in part on [reasonably certain] expectancies.").

129 *See* Meridian Wood Prods. Co. v. United States, 725 F.2d 1183, 1191 (9th Cir. 1984).

130 *See* Comm'r v. Flowers, 326 U.S. 465, 473–74 (1946) (upholding denial of deduction for business paying worker's commuting cost because the benefit was solely to the worker, not the employer).

131 *See* I.R.C. § 61(a)(7) (definition of gross income).

132 *See* Benenson v. Comm'r, 910 F.3d 690, 700 (2d Cir. 2018) (ruling for taxpayer and finding transaction was not a dividend because transactions at issue were "grounded in economic reality").

133 Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).

134 *See* Loftin & Woodard, Inc. v. United States, 577 F.2d 1206, 1215 (5th Cir. 1978).

III. Application of the Constructive Dividend Rule to Securities Fraud Cases

The economic, substance-over-form approach of the constructive dividend rule lends itself to application in a securities fraud context. This Part examines the proposed solution of applying the constructive dividend rule to the disgorgement remedy and its compatibility with the fraudulent scheme exception. The constructive dividend analysis offers a clearer and more administrable alternative to the current approach to disgorgement, although remaining within the boundaries set by precedent.[135]

A. The Constructive Dividend Approach Is More Administrable than Determining What Expenses Were Incurred "Directly in the Commission of the Wrong"

The fraudulent scheme exception endorsed in *Liu* is sometimes characterized as denying deductions for "expenditures incurred directly in the commission of the wrong."[136] On this basis, courts will sometimes deny deductions for expenses, such as marketing expenses, that attracted investors to the scheme.[137] The constructive dividend approach turns on slightly different reasoning: a transaction that is to the benefit of the defendant or the fraudulent scheme supports the "commission of a wrong."[138] Given the complexity of financial fraud, it is often simpler to look to the beneficiary of a given transaction than it is to ascertain whether an expense was "incurred directly in the commission" of a fraudulent scheme.[139]

To determine whether a claimed expense should be deducted from the amount to be disgorged, courts should apply the constructive dividend rule and examine whom the transaction benefitted. This approach has the advantages of clarity and predictability. In securities fraud cases, courts have looked to whether a fee was on an arm's length basis to determine its legitimacy, just as they would do with constructive dividends.[140] The Supreme Court has endorsed tax law's focus on economic analysis, noting "[i]n applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction

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135 *See infra* Section III.B.

136 *See* Restatement (Third) of Restitution & Unjust Enrichment § 51 cmt. h, illus. 21 (Am. L. Inst. 2011).

137 *E.g.*, SEC v. Fisher, No. 21-60624, 2022 WL 13650848, at *4–5 (S.D. Fla. Oct. 21, 2022).

138 Restatement (Third) of Restitution & Unjust Enrichment, § 51(5)(c) (Am. L. Inst. 2011).

139 *Id.*

140 SEC v. Complete Bus. Sols. Grp., No. 20-CV-81205, 2024 WL 4826059, at *12 (S.D. Fla. Nov. 18, 2024); *see also* Obeslo v. Empower Capital Mgt., LLC, 85 F.4th 991, 995 (10th Cir. 2023).

rather than to the particular form the parties employed."[141] Under a constructive-dividend-based model, a defendant would be able to predict the outcome of a disgorgement order by looking at the economic consequences of the actions at issue rather than guessing how the court will characterize the form of a particular transaction.

The constructive dividend doctrine has long been applied in cases of financial fraud in a tax context. In 1956, the Eighth Circuit affirmed a finding of a constructive dividend where the owner of a dairy business had diverted sales receipts for his own use and benefit.[142] Applying the constructive receipt doctrine and citing substance over form,[143] the court found that a defendant has received a benefit when cash "is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it."[144] Using this logic, investor funds that have been withdrawn or otherwise beneficially used by a defendant should be considered a constructive dividend and included in disgorgement accordingly.

B. The Constructive Dividend Rule Satisfies the Reasonable Approximation Standard and Associated Burden Shifting in Securities Fraud Cases

In securities fraud cases, the burden of proof plays an important role in determining which party faces the task of proving what can be complex financial structures.[145] The constructive dividend rule satisfies the reasonable approximation standard required to establish disgorgement amounts.[146] In its enforcement actions, the SEC typically presents testimony of an Enforcement Division accountant regarding the flow of assets from a fraudulent undertaking to meet their initial burden under the reasonable approximation standard.[147] The defendant must then offer proof of additional deductions.[148] This is similar to the posture of

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141 Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978); *see also* Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 255 (1939) ("In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding.").

142 Dawkins v. Comm'r, 238 F.2d 174, 178–80 (8th Cir. 1956).

143 *Id.* at 177 ("Taxation is more concerned with substance than with form. The command and control of the property and the enjoyment of its economic benefit are recognized as proper bases for taxation.").

144 *Id.* at 178 (quoting Rutkin v. United States, 343 U.S. 130, 137 (1952)).

145 *See supra* notes 57–60 and accompanying text.

146 *See supra* notes 54–65 and accompanying text.

147 *See, e.g.*, SEC v. Voight, No. H-15-2218, 2021 WL 5181062, at *7 (S.D. Tex. June 28, 2021); SEC v. Camarco, No. 19-1486, 2021 WL 5985058, at *1 (10th Cir. Dec. 16, 2021).

148 *See* SEC v. de Maison, Nos. 18-2564, 21-620, 2021 WL 5936385, at *2 (2d Cir. Dec. 16, 2021).

tax cases in which the constructive dividend rule is applied, where the government's determination of a payment deficiency benefits from a "presumption of correctness" which a taxpayer must rebut.[149] The burden then shifts to the government to produce credible evidence.[150] In both types of cases, an initial showing of evidence is sufficient to make a case for enforcement, and it is then up to the defendant to prove that less money should be owed.

Even under a reasonable approximation standard, the breadth and level of complexity in securities fraud cases means that courts can be faced with very technical accounting issues when trying to determine the correct amount of disgorgement. Under the current standard, defendants that are mindful of this may adopt a strategy of rebutting the government with new accounting calculations and financial models of ever-increasing granularity and complexity.[151] Disputing these models could devolve into costly litigation battles, particularly against sophisticated defendants with extensive resources.[152] Applying the constructive dividend model and showing how the defendant benefitted from a series of transactions, however, could avoid the potential arms race and clear the reasonable approximations hurdle, particularly when accounting for the risk of any uncertainty borne by the defendant.[153] For example, a defendant retaining a sum of cash from the scheme would accrue a benefit that could be reasonably approximated.[154] A constructive dividend approach would meet the initial burden of a reasonable approximation by focusing on the economic substance of a transaction.

C. The Constructive Dividend Rule Would Clarify the Deductibility of Expenses in Liu

The utility of the constructive dividend approach is apparent when applying it to the transactions at issue in *Liu* on remand from the Supreme Court.[155] Using the approach, the court would look to who benefitted from a particular transaction, thereby receiving "wrongful gains

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149 *See* United States v. Janis, 428 U.S. 433, 440–41 (1976).

150 *See* I.R.C. § 7491.

151 *See generally* J.W. Verret, *Disgorgement Accounting After* Liu v. SEC *in Securities Enforcement Cases*, 87 Alb. L. Rev. 285 (2024).

152 *See id.* at 330 (discussing use of expert testimony in dealing with SEC enforcement staff); RSM, Limiting SEC Disgorgement: The Law and Accounting of "Legitimate" Expenses After *SEC v. Liu* 6 (2021), https://rsmus.com/content/dam/rsm/insights/services/risk-fraud-cybersecurity/1pdf/limiting-sec-disgorgement.inline.pdf [https://perma.cc/TUX6-JCQN] ("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.").

153 *See supra* notes 61–65 and accompanying text.

154 *See infra* Section III.C.

155 *See supra* notes 92–99 and accompanying text.

'under another name.'"[156] Contrary to the district court's deference to the defendant's assertions, the administrative fee payments to a marketing firm closely associated with a defendant, to wit, "my wife's company,"[157] constitute a constructive dividend because defendants benefitted from it by keeping the money.[158] Accordingly, they are not deductible under this approach. Similarly, the defendant's "exorbitant salaries"[159] are a classic case of a constructive dividend: "'inequitable deductions' . . . for personal services."[160]

Some payments would be allowable deductions under the constructive dividend approach. The lease payments, just as contemplated by the *Liu* majority,[161] are legitimate expenses, not a disguised distribution to the owner, and are thus deductible. This is contrary to the overhead costs assertion in some district courts, which reasons that legitimate fixed costs would be incurred regardless of the fraudulent undertaking and are thus not deductible.[162] Legitimate, deductible expenses under *Liu* can include a wide range of outlays, depending on the purpose. Despite the district court's reasoning, the purchase of a genuine medical device from a legitimate vendor, as contemplated by the *Liu* court, has "value independent of fueling a fraudulent scheme."[163] The defendants had no interest in the medical device vendor and, so, the payment was not the disguised disbursement of corporate earnings that would constitute a constructive dividend.[164] Under the constructive dividends approach, the purchase cost should be deducted accordingly from the disgorgement amount. Applying the constructive dividends approach to the *Liu* scheme illustrates that the rule is more administrable than the alternative approaches.

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156 Liu v. SEC, 591 U.S. 71, 92 (2020) (quoting Rubber Co. v. Goodyear, 76 U.S. (9 Wall.) 788, 803 (1869)).

157 SEC v. Liu, No. SACV 16-00974, 2021 WL 2374248, at *4 (C.D. Cal. June 27, 2021).

158 *See id.* at *4 (noting that defendant Wang was identified as the President, and her mother had an ownership interest).

159 *Id.* at *8.

160 *Liu*, 591 U.S. at 92 (quoting Root v. Ry. Co., 105 U.S. 189, 203 (1881)); *see also* Toll, *supra* note 125, at 216 (naming "excessive compensation" as a constructive dividend); Healy v. Comm'r, 345 U.S. 278, 280 (1953) (upholding the determination of excessive corporate officer compensation as a transfer of corporate property).

161 *See Liu*, 591 U.S. at 92.

162 *See, e.g.*, SEC v. Fisher, No. 21-60624-Civ, 2022 WL 13650848, at *4 (S.D. Fla. Oct. 21, 2022). Conversely, it is possible to distinguish between legitimate and illegitimate overhead expenses and deduct the allocation of legitimate overhead from the disgorgement amount. *See* RSM, *supra* note 152, at 5.

163 *Liu*, 591 U.S. at 92.

164 *Cf.* Paramount-Richards Theatres v. Comm'r, 153 F.2d 602, 604 (5th Cir. 1946) (finding that provision obligating the company to take out a life insurance policy with the shareholder's estate as beneficiary "appropriated corporate funds to [the shareholder's] benefit," and did not constitute "ordinary and necessary expenses of a corporation").

D. Potential Implementation and Issues

One challenge to using the constructive dividend approach is taking the constructive dividend out of its native tax field and introducing it into the securities fraud context. This Note's constructive dividend solution could be implemented by parties in disgorgement actions citing constructive dividend precedent in their briefs. Additionally, courts could take judicial notice of the constructive dividend doctrine when evaluating proposed disgorgement amounts.[165]

A further advantage of looking to tax law is that there is a wide body of existing caselaw applying the constructive dividend rule. The U.S. Tax Court hears most cases, but taxpayers have the option of pursuing their claims in federal district court.[166] Circuit courts have consistently upheld the constructive dividend rule.[167] The breadth of existing caselaw on the topic, often dealing with complex financial transactions, ensures that courts would have precedent available when confronting securities fraud cases.

A logical limit on the constructive dividend approach is that for there to be dividends, there must have been profits at some point. At common law, the corporation must have enough accumulated profits to be able to pay a dividend.[168] This may pose an issue when an entity involved in the scheme is bankrupt, as may well be the case after a scheme unravels. This is not just a collection challenge, as with a tax bill coming due, but rather a measurement problem. In most tax cases, the government seeks to avoid this issue by requiring taxpayers to report their income on a cash basis, i.e., when it is received.[169] In securities fraud cases, the court could instead look to the status of the enterprise when it was successful, as it likely was when defendant extracted money from it. Both before and after *Liu*, courts have held that the "defendant's current financial situation, or any hardship that disgorgement

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165 The constructive dividend approach also has value in application to other fields of agency enforcement in which the government seeks disgorgement. Several other federal enforcement agencies routinely seek disgorgement as a remedy and could apply similar logic and analysis, including the Commodities Futures Trading Commission, the Federal Trade Commission, and the Food and Drug Administration. *See* Gabaldon, *supra* note 25, at 1663. Similar to the SEC's power, these agencies saw their ability to seek disgorgement grow from the general equity jurisdiction of the district courts. *See id.*

166 *See* I.R.C. § 7442 (specifying U.S. Tax Court jurisdiction); *id.* § 7429(b)(2)(A) (providing for U.S. district court review of Internal Revenue Service actions).

167 *See, e.g.*, Crosby v. United States, 496 F.2d 1384 (5th Cir. 1974); Benenson v. Comm'r, 910 F.3d 690 (2d Cir. 2018); Dawkins v. Comm'r, 238 F.2d 174 (8th Cir. 1956).

168 *See* Aiken v. Peabody, 168 F.2d 615, 617 (7th Cir. 1947).

169 I.R.C. § 451(a) ("The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.").

would impose, are not factors to be considered in determining disgorgement."[170] With the constructive dividend approach, courts evaluate the transactions in their proper financial context. This factual inquiry elevates substance over form.[171]

Conclusion

The constructive dividend rule offers a way to cabin disgorgement within the confines of equity as set forth in *Liu*. Focusing on the flow of benefits among defendants and their affiliates offers a concrete way to measure net profits as required by the Court's precedent, while preserving the fraudulent scheme exception. Instead of trying to assign a fraudulent character to particular streams of money, the logic of constructive dividends focuses on the economic reality of a given transaction to determine its deductibility. The constructive dividend approach allows for robust agency enforcement while staying within the proper boundaries of the disgorgement remedy. Thus, courts should apply constructive dividend caselaw in navigating *Liu*'s fraudulent scheme exception and the calculation of disgorgement.

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170 SEC v. Spartan Sec. Grp., Ltd., 620 F. Supp. 3d 1207, 1225 (M.D. Fla. 2022), *appeal filed*, No. 22-13129 (11th Cir. Sept. 16, 2022) (citing SEC v. Warren, 534 F.3d 1368, 1370 (11th Cir. 2008)); *see also* SEC v. Molen, 704 F. Supp. 3d 1341, 1346 (N.D. Ga. 2023) ("[A]bility to pay is not a defense to disgorgement.").

171 *See supra* Section II.B.