Another fine mess

Amy Taylor, Toby Duthie & Derek Patterson of Forensic Risk Alliance discuss the underlying rationale, dynamics and challenges in presenting profits to authorities that are calculating potential disgorgement and financial penalties

“This Court never allows a man to make profit by a wrong.” This relatively well-known statement from Lord Hatherley in Jegon v Vivian (1870–1871) seems entirely in line with today's enforcement climates. With an increasingly global and transparent financial system there is a growing public, political and judicial will – and ability – to ensure that unlawful conduct should not pay. Further it is not just the USA, but many other jurisdictions (UK, Canada, Switzerland, Germany, Brazil, the Netherlands, China, etc) are entering the fray in terms of national and international enforcement efforts.

This trend manifests itself in various ways: public outrage; governmental inquiries; increased prosecutions of individuals; shareholder activism; vigilantism (ie, Panama Papers and others) and the ever-growing number and value of regulatory fines.

For the most part these fines typically are based on the profit or “gain” realised by the perpetrator, or the losses suffered by the victims – which may or may not be synonymous. Others can be based on a percentage of tainted revenue or the volume and/or value of illicit payments made.

Evidence of the increased fines can frequently be found in the headlines – some particularly dramatic recent examples include the following.

**VimpelCom**

VimpelCom, an Amsterdam-based telecoms company, entered into settlement resolution with the US Department of Justice (DOJ), the US Securities and Exchange Commission (SEC) and Dutch authorities in February. The settlement amount is the sixth largest FCPA enforcement action, requiring a total payment of $795 million: US$397.5 million to the Dutch authorities; US$230.1 million in criminal penalties to the DOJ, and the remaining US$167.5 million to the SEC for disgorgement and pre-judgment interest.

**BP**

In 2015, oil and gas company BP agreed to pay US$18.7 billion to settle US federal and state claims, marking this the largest environmental fine ever charged. BP will pay fines and natural resource damages totalling US$12.8 billion for Clean Water Act violations, US$1 billion will be split across 400 local government entities, and US$4.9 billion will be paid for economic claims made by five states. This is in addition to US$5 billion BP had to previously pay as part of a criminal settlement. Further, in 2012 BP separately agreed to pay US$7.8 billion (an initial estimate) in a civil settlement with Gulf Coast residents.

**HSBC**

In 2012, the US Senate investigation of UK bank HSBC resulted in US$1.9 billion in money laundering penalties. Separately, HSBC was fined US$2.3 billion for mis-selling financial products in the UK. In 2015 HSBC agreed to pay US$285 million in the US to settle investor claims related to fixing global foreign exchange rates. More recently, in February 2016, HSBC reached another $601 million settlement over charges of “abusive mortgage practices” with the DOJ, the Department of Housing and Urban Development, the Consumer Financial Protection Bureau and 49 states.
Banking fines in particular have become so large and so frequent that it is difficult to take note of any that do not run into the hundreds of millions of dollars. The tally to date, since the financial crisis, amounts to around US$235 billion. Underlying these fines are cases relating to benchmark manipulation, sanction violations, forex manipulation, financial miss-selling and so on. Further, the banking misconduct bill is expected to rise by tens of billions of dollars, as many politicians, regulators and industry observers continue to assert that more needs to be done to deter wrongdoing in the future.

We foresee no near-term end to banker-bashing, although the peak may have finally passed. This is due, in part, to the long-tail nature of the underlying conduct and the steady speed at which regulatory enforcement and civil follow-on litigation run. It is not uncommon for matters – from the first investigative instance to the final civil compensation claim – to last for a decade (or more).

The extent of the duplication and coordination between US regulators and others is also noteworthy. Where banks are concerned, the DOJ, the SEC; the New York Department of Financial Services, the Commodity Futures Trading Commission; and the US Treasury have all punished the same misconduct in symphony, and sometimes acting along with other international regulators too (the UK’s Financial Conduct Authority, Germany’s BaFin and so on).

Overall, the justice system worldwide will continue its enforcement efforts aggressively and not just against banks. Corporations and individuals that infringe on global compliance rules regardless of business sector are increasingly susceptible to fines and prosecution. The well-known US Foreign Corrupt Practices Act (FCPA) settlements graph (above) summarises this aptly.

Taking a step back, on average, settlement quantum (total fines divided by number of matters) for FCPA (civil and criminal) settlements rose from around US$7 million in 2005, to over US$150 million in 2014.

While 2015 might appear to be an enforcement anomaly, it reflects the lumpy nature of enforcement-related settlements, as well as non-US agencies increasingly spearheading the enforcements. For example, the recent US$795 million VimpelCom settlement in February 2016 was a joint effort between the US and Dutch authorities. Moreover, based on various companies’ stated financial accounts and FCPA-related policy developments, 2016 is shaping up to be an important financial milestone in anti-corruption enforcements.

Additionally, 2015 saw the first large bribery enforcement action in the Netherlands, against SBM Offshore, totalling US$240 million. The DOJ and the SEC declined to prosecute (though the DOJ reopened its investigation in February). We understand US authorities provided heft and experience in conjunction with the Dutch authorities. This kind of coordinated activity would also, at least superficially, have driven down the 2015 FCPA results. Additionally, in July 2016 SBM Offshore signed a settlement agreement with Brazilian authorities and Petrobas to pay fines of US$342 million, including a cash penalty and discounts on future work on an existing contract with Petrobas.

This article is intended to provide some practical financial insight. It does not address critical legal issues and analysis.
The basics – calculating gain, profit, disgorgement...

The best guide to calculating “profit” or “pecuniary gain” is to use past cases. This requires us to look to the US, where the biggest volume of settled cases lie, and where Federal Sentencing Guidelines (for criminal penalties) and the Securities Exchange Act (for civil disgorgement matters) apply. Also, in practice, in multi-jurisdictional cases, with a US nexus, these statutes will de facto be driving the calculation explicitly or implicitly – an early and explicit example of this was the AkerzNobel/FCPA settlement back in 2006. Here the company, in its settlement with the SEC, agreed to pay US$750,000. The Justice Department, however, took a different route and agreed that the company was obligated to settle with the Dutch authorities for a minimum amount of €381,000 payable within 180 days or else the US would come back for US$800,000. These types of global, but often US-driven settlements, like Innopec (UK and US) and again VimpelCom and to a degree SBM, are likely to be a growing feature.

In terms of calculation mechanics, it is important to remember that for criminal penalties the profit or pecuniary gain amount typically drives and/or builds the base for the criminal penalties and disgorgement, therefore can be subject to a multiplier – for example, up to four times in the USA and the UK. So every dollar, euro, yen or pound “added” is potentially subject to magnification. Further, the profit assessment can drive both a sanction and the disgorgement of gains. Also typically criminal penalties in most jurisdictions are not tax deductible – further increasing the true bottom line financial cost.

Past cases indicate that there are key points to keep in mind: it is important to distinguish between legally and illegally obtained profits, to establish a link between unlawful activity and profit to be disgorged, and the calculation needs to be a reasonable approximation and point to events that intervened/influenced the profits obtained. Moreover, in order to determine the profits implicated by the illicit payments, several factors must be considered: the nature of the company’s business, the nature of the illicit payments and if these were related to a specific contract, location, segment, division, product, or country, and where/if the illicit payments were recorded in the financial statements. Once the nature and scope of the potential profits are determined, certain deductions and add-backs should be taken into consideration (see table).

Many prosecutors and statutes refer to gross profit when requesting profit data. It is clear that this is based on legal perception and should not be not considered synonymous with a company’s accounting gross profit. It is important to remember that most international businesses operate reporting hierarchies tailored to their own organisation, systems and objectives, and even within such businesses more than one reporting hierarchy can be in operation at the same time. This reinforces the fact that a request for gross profit should not be considered as a set number or methodology. For example, if a project company exists purely for the management of a large project, why wouldn’t all of the operating costs be deductible, including all overhead costs? They are all empirically “variable” as the project company will be closed at the conclusion of the project. On the other hand, if the tainted contract relates to the sale of a small number of widgets (out of a production line producing millions of widgets), then it would perhaps be less objectively reasonable to deduct production line overhead as arguably these costs would have been incurred anyway.

All income statement line items should therefore be determined by their nexus to the contract and/or connection to the misconduct. How they were accounted for contemporaneously is important but may not fully reflect the economic reality. For example, whether something is allocated to a specific contract (or not) and whether it is accounted for below or above the operating profit line can be down to a number of judgmental or operational factors which do not or cannot fully reflect the cost’s true nexus to a contract. In reality, extensive revenue, cost analysis and stratification is required to come to an objective and reasonable estimation as to the directly attributable revenue and costs.

There are also other important factors: whether the profit was generated during a period when all of the applicable anti-bribery laws were in force; the start and end points of the profit-generating cash flows; the currency and method of bribery payments, who paid the bribes (and how) and who authorised them; the effect the bribe had on securing the contract and underlying revenue; and potential benefits for pricing.

The treatment of illicit payments can change based on where the payments were recorded (ie, their expense category). If the illicit payments were recorded in an expense line item that has a nexus to the implicated revenue, for example, in a G&A and C&A expense, then the illicit payments must be “added back”,

**Basic Profit Disgorgement Calculation Outline**

<table>
<thead>
<tr>
<th>Implicated revenue</th>
<th>= Implicated gross profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>− (minus) cost of goods sold (COGS) related to implicated revenue</td>
<td>− (minus) any directly attributable “variable” costs (R&amp;D, S&amp;M, G&amp;A directly attributable to the contract)</td>
</tr>
<tr>
<td>− (minus) any overhead allocations “variable” costs (directly attributable to the contract)</td>
<td>− (minus) any other allowable deductions (directly attributable to the contract, eg liquidated damages, warranty costs, transport, insurance and finance costs etc)</td>
</tr>
<tr>
<td>= Implicated operating profits (closer to the SFO “gross profit” or “base benefit”)</td>
<td></td>
</tr>
<tr>
<td>+ (add) illicit payments (if applicable)</td>
<td>+ (add) non-cash charges (depreciation and amortisation)</td>
</tr>
<tr>
<td>= Total profits to be disgorged</td>
<td></td>
</tr>
</tbody>
</table>

**Colour Key:**

- Line items sometimes referred to as “below the line deductions”
- Line items sometimes referred to as “add-backs”

First published in GIR Magazine Volume 3 • Issue 3, August 2016
Calculating profits

which creates a reduction in the cost (increasing the profit) considered for disgorgement. However, if the payments were not recorded in a line item applicable for disgorgement calculation, then there is no need to add them back as they are not being deducted for the purpose of the calculation.

The above may sound simple but it rarely is. One of the challenges in these calculations is a lack of clear precedents – settlement agreements and judgments on both sides of the Atlantic are light on specific detail and methodology, and perhaps deliberately so. This typically plays into the hands of the prosecutors. The way to counter this is through tribal knowledge. Engage a team that has assisted such calculations on a number of cases. Get into the weeds as early as possible and make sure you and your team understand the data. Keep the big picture in mind – does the company typically make money on these types of contracts, and if so how much? Ensure profits presented to regulators can be reconciled to publicly available data. Consider the profit data and approach to the financial calculation of profit early in the regulatory response period, in order to ensure data are pitched correctly to the regulator first time around.

The benefit of this work can be extremely valuable and lead to a settlement number that more accurately reflects the economic value obtained. Again, the above may sound relatively easy but often companies do not implement project or contract-specific accounting (or even if they do, it may not take into account material project or contracts costs – think liquidated damages, cost overruns). Also, big projects/contracts usually span several years and therefore cover multiple accounting periods, legal entities and systems – all of which present significant challenges. These factors, if considered carefully, will also assist boards and directors demonstrate to shareholders that settlement values can be justified, as well as compliance with fiduciary duties (in this context think about the very recent shareholder protests around Goldman CEO Lloyd Blankfein’s remuneration in part due to a US$5 billion regulatory fine).

**Big bad data**

Industry practitioners recognise how challenging imperfect data are when calculating profit at a project or contract level. Identifying the components of profits specific to an alleged misconduct is difficult enough, but it can be worsened by the absence of data, data gaps and inconsistencies, or incorrect data (perhaps subsequently corrected in a different financial accounting period). Such issues can arise from a change in accounting systems and policies, mergers and acquisitions, disposals and so on. Accordingly, the necessary supporting financial data can vary dramatically from case to case. For the most part they should include statutory financial statements, profit and loss statements with account-level detail, breakdown of cost of goods sold, other directly attributable cost breakdowns, and a schedule of illicit payments.

When there are partial datasets, there are remedies that can be considered. Some remedies can be made through assumptions, educated benchmarks, and extrapolating data backwards and forwards to fill data gaps. It is always important to engage with the authorities on these challenges and demonstrate transparency and objectivity.

There is often a perception that large-scale illegality equals large-scale profits, when often this is not at all the case and in fact can be quite the opposite.

**Accounting issues**

Along with incomplete data, other accounting-related issues may present themselves. For example, if subsidiaries are involved there may have been transfer prices for goods or services charged from one entity to another. However, when calculating for disgorgement, only the true economic profit should be considered, not the potentially misleading profit or loss caused by the accounting transfer price or a periodic financial statement snapshot (eg, profits in one year can become big losses in subsequent years and vice versa). Similarly, if accounting procedures and standards experience a change during the years implicated in an investigation, a decision must be made as to which practice is the best presentation of profit.

**Key closing thoughts**

There is a real need to get into the detail early to make sure that the profits receive proper and full consideration. This may also help to drive the overall strategy and equip the company to manage regulatory expectation better. There is often a perception that large-scale illegality equals large-scale profits, when often this is not at all the case and in fact can be quite the opposite.

There are a few other other things to keep in mind, as listed below.

**Double jeopardy**

Companies need to maintain a multi-jurisdictional outlook to ensure, to the greatest extent possible, that they are able to negotiate a global settlement – both legally and financially – without paying twice or more. This can be done by sharing fine and disgorgement revenue and/or by allocating specific contracts or revenue streams to specific prosecutors. In either case, the profit calculation methodology needs to be synchronised.

**Work closely with counsel and keep up to date with new case law**

Read the small print and read between the lines: while we have said that there is a lack of precedent, careful reading of key plea agreements can allow for strong inferences to be drawn as regards below-the-line cost deductibility, identifying tainted elements of a contract’s profits (rather than taking the whole), future revenue and so on.
Disgorgement under federal securities law could either be compensatory (tax-deductible) or punitive (not tax-deductible). In the past, penalties have typically not been deductible. Recent case law on this should be factored in, especially in higher tax jurisdictions.

Statute of limitations vary extensively between jurisdictions. It’s worth noting that a recent opinion by the US Court of Appeals for the Eleventh Circuit seems to definitively establish that the statute of limitations for disgorgement purposes can now be limited to five years before the case was first filed.

Call for harmonisation
Given the size and scale of these fines, combined with inevitable double jeopardy issues, corporates should be engaging with governments and civil society to drive greater clarity around key principles that should underpin these calculations. There is a need for multi-jurisdictional harmonisation. Typically, engagement with the authorities is done when corporates are already in a defensive mode – ie, when resolving a specific investigation. They are rarely, if ever, done on a policy level. There is a need to push back against a trend where fines often seem to be benchmarked more against each other, rather than being based on the true underlying illicit profits. Equally, illicit profits can and should only ever be one significant part of the bigger fine picture and the related discussions between clients, attorneys and regulators.

Harmonisation discussions would also allow a dialogue to commence on other critical issues, such as how best to achieve genuine redress for victims, rather than just punishing perpetrators.