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## Earnings Management and the Business Judgment Rule: An Essay on Recent Corporate Scandals

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# EARNINGS MANAGEMENT AND THE BUSINESS JUDGMENT RULE: AN ESSAY ON RECENT CORPORATE SCANDALS

Franklin A. Gevurtz<sup>†</sup>

I.	THE <i>KAMIN</i> CASE.....	1263
A.	<i>An Overview</i> .....	1263
B.	<i>Kamin and the Outer Bounds of the Business Judgment Rule</i> .....	1264
C.	<i>Kamin As a Green Light for Earnings Management</i> .....	1267
II.	RETHINKING <i>KAMIN</i> 'S UNDERLYING PREMISES ABOUT EARNINGS MANAGEMENT.....	1269
A.	<i>The Efficient Markets Critique</i> .....	1269
B.	<i>The Legitimacy of Seeking Higher Stock Prices Through Earnings Management</i> .....	1270
III.	CONCLUSION .....	1277

The year 2002 will go down as a dark year in corporate history, as scandals involving misleading financial reporting designed to inflate earnings and hide losses engulfed companies such as Enron, WorldCom, Global Crossing, Tyco, and others.<sup>1</sup> Not surprisingly, this corporate meltdown has prompted a wealth of commentary laying the blame on a variety of doorsteps. These include: decreased enforcement of securities laws due to a combination of legislative barriers to private lawsuits;<sup>2</sup> a lack of resources for the Securities and Exchange Commission ("SEC"), coupled with rulings limiting the liability of indirect participants in securities fraud;<sup>3</sup> the replacement of professionalism with a business-

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1. See generally Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Might Just Work)*, 35 CONN. L. REV. 915 (2003) (providing an overview of these scandals).

2. See, e.g., Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1161-63 (2003).

3. *Id.* at 1141, 1159-61.

generating ethos among the partners of major accounting firms;<sup>4</sup> pressure on securities analysts to make favorable statements about companies in order to promote investment banking business for the firms employing the analysts;<sup>5</sup> unintended consequences of the increasing tendency to tie management compensation to stock performance;<sup>6</sup> lack of independence of directors on the board of Enron and other companies;<sup>7</sup> inadequacies in the regulation of derivatives;<sup>8</sup> and the irrational behavior of investors themselves.<sup>9</sup>

To this list of whom to blame, I would like to add my own pet villain, which, I suggest, played at least a non-trivial role in sowing the seeds for these scandals. My villain is the much noted New York trial court decision in *Kamin v. American Express Co.*<sup>10</sup> In this decision, the court held that it was entirely appropriate, under a doctrine known as the business judgment rule, for the directors of American Express to cause the company to lose millions of dollars for the sole purpose of improving reported earnings and thereby maintaining the price at which the company's stock traded.<sup>11</sup> Having given such a carte blanche for the practice now referred to as earnings management,<sup>12</sup> it is not surprising that eventually there would be a cascade of scandals that, at its core, involves corporations engaging in transactions lacking real substance and designed simply to improve reported earnings.

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4. See, e.g., Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1168 (2003).

5. See, e.g., Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 145-46 (2002).

6. See, e.g., Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1246-47 (2002).

7. See Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 871-74 (2003).

8. See Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May,"* 48 VILL. L. REV. 1245, 1262-80 (2003).

9. See John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004).

10. 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976), *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).

11. *Id.* at 812.

12. See generally Gregory S. Rowland, Note, *Earnings Management, the SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUM. L. REV. 168, 207 n.5 (2002) (defining "earnings management").

I. THE *KAMIN* CASEA. *An Overview*

Normally, one should be leery of attaching too much significance to just one New York trial court decision affirmed by an intermediate appellate court without a written opinion. Nevertheless, for a substantial fraction of the current generation of corporate attorneys, the New York trial court's decision in *Kamin* forms part of their essential understanding of the duties of corporate directors, if, for no other reason, than because of the opinion's inclusion in many of the leading casebooks used to teach the subject.<sup>13</sup>

*Kamin* involved a shareholders' derivative complaint against the directors of American Express Co. who had approved distributing an in-kind dividend. This dividend consisted of shares of stock in another company (Donaldson, Lufken & Jenrette ("DLJ")), which American Express had purchased some years before as an investment and which had declined substantially in value.<sup>14</sup> The plaintiffs contended the directors should have sold the DLJ shares at a loss rather than distributing them to the American Express stockholders.<sup>15</sup> In this manner, American Express could have obtained a capital loss deduction that would have saved American Express around \$8 million in taxes.<sup>16</sup>

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13. See MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 536 (8th ed. unabridged 2000); WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 316 (5th ed. 2003); JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 284 (5th ed. 2003); JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 198 (5th ed. 2000).

14. *Kamin*, 383 N.Y.S.2d at 809. American Express had acquired the DLJ stock for almost \$30 million, and the stock was only worth \$4 million when distributed. *Id.*

15. *Id.* at 809-10.

16. *Id.* at 811. From a tax planning standpoint, the board's decision made no sense. By selling the DLJ stock, American Express evidently could have recognized a loss of around \$25 million. *Id.* Given the apparent size and nature of American Express's other income, and the applicable marginal tax rates, reduction in American Express's taxable income by recognizing this loss would have lowered the company's tax bill by \$8 million. *Id.* By contrast, with the in-kind dividend, not only was American Express not able to recognize the \$25 million loss on its tax return, its shareholders received a basis (the sum used in computing gain or loss for tax purposes on the disposition of property) equal to no more than the current fair market value of the DLJ stock at the time the shareholders received the dividend, rather than equal to the higher amount paid by American Express

The board's rationale for the in-kind dividend lay in the accounting treatment of the transaction.<sup>17</sup> This treatment (although there was some dispute about this) paralleled the tax treatment. Just as distributing the stock as an in-kind dividend, rather than selling the shares, avoided recognizing a loss that would have reduced American Express's taxable income, it also avoided recognizing a loss that would have lowered the income reported in the corporation's published financial statements.<sup>18</sup> Faced with a transaction that cost the corporation \$8 million, all for the purpose of avoiding reporting a loss in the company's published financial statements, the court granted the defendants' motions in the alternative to dismiss the complaint as not stating a cause of action or for summary judgment.<sup>19</sup>

#### B. *Kamin and the Outer Bounds of the Business Judgment Rule*

One reason for *Kamin's* prominence in corporate law casebooks is because of its illustration of a rather extreme view of a doctrine known as the business judgment rule. Different courts define the business judgment rule differently.<sup>20</sup> To some courts, the so-called rule is simply an overly dramatic way of stating that directors of a corporation are not liable for decisions the directors make which go awry, unless the directors breached their duties of loyalty or care, and that bad results do not, in themselves, show a breach of the duty of care (negligence).<sup>21</sup> To most courts, however,

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for the DLJ stock. *Id.*; see 26 U.S.C. § 301(d) (2004). Hence, the dividend destroyed the potential for anyone (including American Express's shareholders) to obtain the loss deduction on the DLJ stock's pre-distribution decline in value. Moreover, the American Express shareholders still had to recognize the dividend as income, just as they would have had they received cash proceeds from the sale of the DLJ shares by American Express (*e.g.*, 26 U.S.C. § 301 (2004)) since there is no indication that American Express owned enough shares in DLJ for a tax-free spin-off (*e.g.*, 26 U.S.C. § 355(a)(1)(A) (2004)). Further, even if the American Express shareholders had received the DLJ stock in a tax free spin-off, American Express's tax savings on recognizing the loss would have far exceeded the total tax paid by American Express's shareholders on receiving a \$4 million cash dividend instead of \$4 million worth of stock in a tax-free spin-off.

17. *Kamin*, 383 N.Y.S.2d at 809.

18. *Id.*

19. *Id.* at 815.

20. See, *e.g.*, Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?* 67 S. CALIF. L. REV. 287, 290-303 (1994).

21. See, *e.g.*, *Litwin v. Allen*, 25 N.Y.S.2d 667, 678 (N.Y. Sup. Ct. 1940). "In other words, directors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment or for mistakes

the business judgment rule has greater significance. It serves to insulate the directors from liability for ordinary negligence in making business decisions, so long as the directors are not in a conflict of interest in making the decisions. For example, in Delaware, directors are not liable for a business decision (so long as the decision does not involve a conflict of interest) unless they made the decision in bad faith or with gross negligence.<sup>22</sup> Alternatively, other courts have interpreted the rule as limiting the courts' ability to review the substantive reasonableness of the directors' decision (as opposed to the process by which the board reached the decision).<sup>23</sup> At the extreme, some courts view the business judgment rule as placing beyond challenge pretty much any decision made by directors without a conflict of interest, no matter how ill-conceived the decision, so long as the directors thought their action was somehow in the best interest of the corporation.<sup>24</sup> Language in the *Kamin* opinion places this decision in this extreme camp.<sup>25</sup>

Although *Kamin* takes an extreme view of what a complaining shareholder must allege in order to hold directors liable, it would be a mistake to read the opinion as placing any disinterested board decision beyond judicial review. To understand what limits remain on directors' decisions even under *Kamin*, it is helpful to try to reconcile the opinion with two previous New York trial court decisions also involving the business judgment rule.

*Litwin v. Allen*,<sup>26</sup> while merely another New York trial court

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while acting with reasonable skill and prudence." *Id.*

22. See, e.g., *Smith v. Van Gorkum*, 488 A.2d 858, 873 (Del. 1985).

23. See *Auerbach v. Bennett*, 393 N.E.2d 994, 996 (N.Y. 1979); see also JONATHAN R. MACEY, *PRINCIPLES OF CORPORATE GOVERNANCE* § 4.01(c) (1998).

24. See *Schlensky v. Wrigley*, 237 N.E.2d 776, 778 (Ill. App. Ct. 1968).

25. *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 811 (N.Y. Sup. Ct. 1976), *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).

Section 720(a)(1)(A) of the Business Corporation Law permits an action against directors for "[t]he neglect of, or failure to perform, or other violation of his duties in the management and disposition of corporate assets committed to his charge." This does not mean that a director is chargeable with ordinary negligence for having made an improper decision, or having acted imprudently. The "neglect" referred to in the statute is neglect of duties (i.e., malfeasance or nonfeasance) and not misjudgment. To allege that a director "negligently permitted the declaration and payment" of a dividend without alleging fraud, dishonesty or nonfeasance, is to state merely that a decision was taken with which one disagrees.

*Id.*

26. 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940).

decision, helped form the understanding of the duties of directors for an earlier generation of corporate attorneys. In its language, the opinion in *Litwin* stands at the opposite extreme from *Kamin* as far as the meaning of the business judgment rule. *Litwin* employs language that suggests that directors, like anyone else charged with breaching the duty of care, will be liable for ordinary negligence.<sup>27</sup> As later readers of the *Litwin* case have pointed out, however, the actual facts of the case involve more than simple negligence.<sup>28</sup> In *Litwin*, the court held the directors of Guaranty Trust Company liable for their decision to purchase \$3 million of debentures.<sup>29</sup> The problem, as the court saw it, was not just that the debentures declined in value, causing Guaranty Trust to incur a loss. Rather, the problem with the directors' action was that the purchase agreement gave the seller the option to repurchase the debentures at the sale price within six months.<sup>30</sup> This meant that while Guaranty Trust faced the risk of loss if the debentures declined in value, Guaranty Trust did not obtain the corresponding potential for gain since, if the debentures appreciated, the seller presumably could exercise its option to repurchase. In other words, the directors had placed the corporation in an entirely no-win situation in which, at best, the company would break even and, at worst, it would suffer serious losses. This goes beyond incurring an unreasonable risk of suffering a loss in order to seek some sort of corporate gain.

In *Gottfried v. Gottfried*,<sup>31</sup> as with *Kamin*, a New York trial court confronted a challenge to the decisions of directors with respect to the declaration of dividends.<sup>32</sup> In *Gottfried*, however, the shareholders' complaint was about the directors' refusal to declare dividends.<sup>33</sup> *Gottfried* arose out of animosity between the shareholders of a closely held corporation—the Gottfried Baking

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27. *Id.* at 699. "There is more here than a question of business judgment as to which men might well differ. The directors plainly failed in this instance to bestow the care which the situation demanded. Unless we are to do away entirely with the doctrine that directors of a bank are liable for negligence in administering its affairs liability should be imposed in connection with this transaction." *Id.*

28. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) (noting the corporate decision in *Litwin* was "so egregious as to amount to a no-win decision").

29. 25 N.Y.S.2d at 691, 700.

30. *Id.* at 700-01.

31. 73 N.Y.S.2d 692 (1947).

32. *Id.* at 693-94.

33. *Id.*

Corporation.<sup>34</sup> The shareholders were the children of the founder of the company and their spouses.<sup>35</sup> The minority faction sued the directors to compel an increase in the dividends.<sup>36</sup> Through the Depression, the company had not declared dividends on the common stock; but with improved prospects at the end of the Second World War, the minority shareholders claimed that the majority had refused to declare dividends for the purpose of starving out the minority so that the minority would sell their shares.<sup>37</sup> The court held that it would uphold the directors' decision with respect to the amount of dividends, absent a showing that the directors acted in bad faith rather than for the corporation's welfare.<sup>38</sup> Finding insufficient evidence of such bad faith, the court granted a judgment for the defendants.<sup>39</sup>

The evident way to reconcile *Litwin*, *Gottfried*, and *Kamin* is to say that a challenged action by a corporate board of directors, at the very least, must have for its subjective goal advancing the interests of the corporation or the shareholders. Under *Kamin*'s view, the court will not balance this goal against the cost of the action to the corporation, as a court might do in a traditional tort case.<sup>40</sup> Nevertheless, costing the corporation millions of dollars must have some arguable utility; otherwise, it would be the equivalent of *Litwin*'s no-win situation and suggestive of bad faith, as the court warned against in *Gottfried*. This meant that the court in *Kamin* had to find some rationale for the directors' action.

### C. *Kamin As a Green Light for Earnings Management*

The rationale for the directors' action that the court accepted in *Kamin* was to avoid reporting a loss in American Express' published financial statements on American Express' investment in the DLJ stock, which, in turn, would have lowered the net earnings reported by American Express to the investing public.<sup>41</sup> Such a report of lower earnings, the court reasoned, could lower the price

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34. *Id.*

35. *Id.* at 694.

36. *Id.*

37. *Id.*

38. *Id.* at 695.

39. *Id.* at 701.

40. *See, e.g.,* United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947) (laying out a formula to balance the burden of avoiding liability with the gravity and likelihood of the resulting harm).

41. *Kamin*, 383 N.Y.S.2d at 811.



at which American Express stock traded on the market, and hence would be bad for the American Express shareholders.<sup>42</sup> In other words, not only was there nothing wrong with seeking to maintain stock prices by hiding a loss, according to the court in *Kamin*, this goal justified giving up \$8 million in tax savings.

Rather than question this goal, the plaintiffs in *Kamin* made two arguments. The first was that proper accounting, according to the plaintiffs' accounting experts, required American Express to recognize the loss, even though American Express distributed, rather than sold, the DLJ stock.<sup>43</sup> The trial court cast this argument aside, noting that the defendants' accounting experts disagreed with the position of the plaintiffs' experts.<sup>44</sup> In addition, the trial court pointed out that after the chief accountant of the SEC raised some questions about the appropriate accounting treatment of the transaction, the SEC did not pursue the matter.<sup>45</sup> The plaintiffs' second argument was that four of American Express's twenty directors had a conflict of interest in voting for the dividend because these four directors were officers and employees of American Express covered by the company's Executive Incentive Compensation Plan.<sup>46</sup> As such, some of the compensation of these four directors depended upon the level of reported earnings. Finding no showing that the four insiders had dominated or controlled the sixteen outside directors, the trial court also rejected this argument.<sup>47</sup>

Looking back now, it is interesting how the two arguments of the plaintiffs in *Kamin* foreshadowed the scandals of 2002. The conflicting views of the plaintiffs' and defendants' accounting experts, and the raised eyebrows (even if no ultimate action) by the SEC, suggest that American Express was pursuing an accounting treatment at the borderline of what was acceptable. Coupled with this aggressive accounting approach was a compensation scheme that gave management an incentive to report higher earnings. In Enron and the other scandals of 2002, corporations pushed the limits of acceptable accounting<sup>48</sup> in search of higher reported

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42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* at 812.

47. *Id.*

48. See Rowland, *supra* note 12, at 9-14 n.5; Anthony H. Catanach, Jr. & Shelley Rhoades-Catanach, *Enron: A Financial Reporting Failure?*, 48 VILL. L. REV.

earnings and higher stock prices that benefited management, much of whose compensation was in the form of stock options and the like.<sup>49</sup> The plaintiffs' attorneys in *Kamin*, however, may have lost the forest in the trees. The plaintiffs' attorneys could have used American Express' abandonment of \$8 million in tax savings as an opportunity to question the very goal of seeking to hide losses and maintain higher stock prices, regardless of what accounting practice allowed. Instead, by retaining experts to discuss the appropriate accounting treatment, the plaintiffs implicitly conceded the legitimacy of the goal.

## II. RETHINKING *KAMIN*'S UNDERLYING PREMISES ABOUT EARNING MANAGEMENT

### A. *The Efficient Markets Critique*

A common critique of *Kamin* from law professors over the last couple of decades is that the directors' action was simply futile.<sup>50</sup> In a sense, the directors' action is like the ostrich that sticks its head in the sand to pretend there is no danger. After all, the plaintiffs in *Kamin* knew about the loss American Express suffered on the investment in the DLJ stock—otherwise, they would not have filed the complaint. Since there is no indication that the plaintiffs had any special access to inside information, it is unlikely that avoiding recognizing the loss in American Express's financial statements kept the loss a secret. Accordingly, one might argue that the directors' action could have no positive effect on the price of American Express shares (thereby suggesting the plaintiffs may have been correct in their innuendo that the real objective was to maintain reported earnings in order for management to receive extra compensation).

This critique is a subset of the efficient capital markets thinking that swept up law professors in the 1980s and 1990s. During the last two decades, legal scholarship increasingly has invoked the so-called Efficient Capital Market Hypothesis<sup>51</sup>—which

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1057 (2003).

49. See Gordon, *supra* note 6.

50. See, e.g., WILLIAM A. KLEIN ET AL., TEACHER'S MANUAL TO BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 207-08 (5th ed. 2003).

51. See, e.g., Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

is a fancy way of saying that stock prices in active trading markets move very rapidly in response to information relevant to a stock, and, thus, the stock's price will incorporate the information in very short order. One key question about the Efficient Capital Market Hypothesis is what types of information it covers. Here, the hypothesis breaks down into three flavors. The weak form states that the price incorporates all information one can glean from looking at past price movements. The semi-strong form holds that the price incorporates all publicly available information. The strong form of the hypothesis holds that the market price incorporates all information, including information not supposed to be known outside the corporation.<sup>52</sup>

Needless to say, the scandals involving Enron and the like have cast something of a damper on this view of the world. After all, not only did the market price of Enron stock fail to impound non-public information about the company's true state (contrary to the prediction of the strong version of the Efficient Capital Markets Hypothesis), the price failed to impound all of the publicly available warnings about the quality of Enron's reported earnings.<sup>53</sup> As a result, the Enron experience undermines even the semi-strong version of the Efficient Capital Markets Hypothesis. What this means is that the professed belief of the directors and the court in *Kamin* that the stock dividend really could hide the loss from the market and maintain the price of American Express shares may not have been as naive as law professors have suggested.<sup>54</sup>

#### *B. The Legitimacy of Seeking Higher Stock Prices Through Earnings Management*

The main problem with *Kamin*, as brought home by the corporate scandals of 2002, is both the court's and the litigants' unqualified assumption that reporting higher earnings to maintain the trading price of American Express stock was a legitimate goal for corporate directors. The only issue under this view is whether

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52. See, e.g., R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE, 290-310 (4th ed. 1993).

53. See, e.g., Gordon, *supra* note 6, at 1235-40.

54. This is not to say that the stock dividend prevented the unreported loss on the DLJ stock from having any impact at all on the price of American Express shares. Some market participants presumably adjusted their evaluation of American Express to reflect their knowledge of the loss. The question is whether the impact would have been greater had the loss shown up in the financial statements.

the directors had slipped the bounds of acceptable accounting practice as a means toward achieving this goal. Even before the scandals of 2002, some writers had questioned whether the goal of hiding losses, itself, was legitimate.<sup>55</sup>

One likely reason for the *Kamin* court's unquestioning acceptance of the goal of higher share prices through higher reported earnings is this goal's proximity to two almost universally accepted goals for corporate directors: maximizing profits for the corporation<sup>56</sup> and maximizing the price at which shareholders are able to sell their stock.<sup>57</sup> The corporate scandals of 2002 demonstrate, however, that there can be a significant difference between maximizing the reported earnings and maximizing the real earnings of a corporation. Moreover, it turns out that once we start examining the goal of maximizing the price at which shareholders are able to sell their stock, this objective becomes much more problematic than typically assumed.

To begin with, there are obviously two parties involved in a stock trade: the seller, for whom high prices are good, and the buyer, for whom high prices are not so good. As the board seeks higher prices for selling shareholders (who will soon not be part of the corporation),<sup>58</sup> one could certainly ask whether the board owes any duty to the buyers (or prospective shareholders, who, upon their purchase, will become part of the corporation). In fact, there is authority suggesting that directors have a fiduciary duty toward prospective shareholders, particularly when it comes to information impacting the purchase of stock. For example, insider-trading cases hold that directors and other corporate insiders have a duty to disclose non-public material information when selling their shares to parties who are not yet shareholders.<sup>59</sup> Admittedly, this disclosure duty only applies if the directors or insiders are the persons selling their shares (since the obligation is to disclose or else abstain from trading);<sup>60</sup> yet, underlying this duty is the notion that directors stand in a fiduciary relationship with prospective, and

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55. See, e.g., FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.1.2(c) n.31 (2000).

56. See, e.g., AM. L. INST., PRINCIPLES OF CORPORATE GOVERNANCE § 2.01(a) (1994).

57. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

58. Using the term in the sense of a collective group, rather than a separate legal entity. See, e.g., ALFRED F. CONARD, CORPORATIONS IN PERSPECTIVE § 69 (1976).

59. See, e.g., *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951).

60. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 227 (1980).

not just current, shareholders.<sup>61</sup> What this means is that any gains the board achieves for selling shareholders, at the expense of the buyers who thereby become shareholders, represents a wash as far as the interests of the parties toward whom the board owes a fiduciary duty. Hence, all other factors being equal, the gains for selling shareholders cannot, under the reasoning in *Litwin*, justify imposing a cost upon the corporation.<sup>62</sup>

In any event, the facts of *Kamin* force us to recognize that there is also the interest of the stockholders who are not selling. On a superficial level, even shareholders who lack immediate plans to sell typically seem happier when the price of their shares is higher rather than lower. On the other hand, it is an interesting question as to whether shareholders without plans to sell would be happier with higher share prices if they knew it was the product of hiding losses (as in *Kamin*) or of other forms of earnings management. In order to keep this essay manageable, let us ignore considerations of real world preferences discovered by studies of behavioral psychology in the economics field,<sup>63</sup> and ask what would make sense from the standpoint of non-selling shareholders.

A recent paper by a trio of business professors argues that earnings management might be in the economic interest of the existing shareholders.<sup>64</sup> The thesis is that earnings management can prevent inefficient meddling by owners in decisions better left to managers. Specifically, without earnings management, owners might overreact to short-term poor performance. Fear of such overreaction, in turn, could lead to suboptimal decisions by managers who might, for example, forgo potentially better

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61. *Id.* at n.8 (basing the duty to disclose or abstain on a fiduciary relationship between parties to the trade, and applying this concept to insiders selling to purchasers who thereby will become shareholders).

62. There is no conflict between this conclusion and the repeated judicial holdings imposing a duty on directors to seek the highest price for selling shareholders in transactions involving sale of control. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985). In these cases, the buyer has an advantage over the selling shareholders who face a collective action problem in negotiating for the highest price. Hence, the board's intervention is appropriate to level the playing field between the purchaser and the selling shareholders, even if the intervention imposes a cost on the corporation.

63. See, e.g., *BEHAVIORAL LAW AND ECONOMICS* (Cass R. Sunstein ed. 2000).

64. ANIL ARYA ET AL., ARE UNMANAGED EARNINGS ALWAYS BETTER FOR SHAREHOLDERS? (Yale ICF, Working Paper No. 02-37, Aug. 2002), at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=322260](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=322260) (last visited Apr. 19, 2004).

investment decisions in favor of decisions that assure at least acceptable short-term results. This is an interesting theory. Yet, reality seems very different. In contrast to the well-documented antics of the owner of the New York Yankees baseball team,<sup>65</sup> it is difficult to find much empirical evidence that owners (or directors) of publicly held corporations are quick to interfere with managers whenever such corporations report poor earnings results.<sup>66</sup>

In contrast to its uncertain advantages, using earnings management to maintain higher share prices might produce a couple of concrete disadvantages to non-selling shareholders. *Kamin* illustrates the first obvious disadvantage. The corporation

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65. See *Trouble in Paradise as Torre, Steinbrenner Fight*, WICHITA EAGLE, Apr. 22, 2003, at 3D.

66. Indeed, it has been well accepted in corporate law literature since the classic work by Professors Berle and Means (ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932)) that shareholders in the publicly held corporation are “rationally apathetic” and will not interfere with management. See, e.g., GEVURTZ, *supra* note 55, at 230, § 3.1.5.a. Moreover, despite some relatively recent instances of boards sacking underperforming CEOs, as a general proposition directors also have been slow to second-guess management based upon short-term poor results. See, e.g., *id.*; see also *The Way We Govern Now*, THE ECONOMIST, Jan. 11, 2003, at 59 (discussing poor board governance in light of corporate scandals involving Enron); MICHAEL C. JENSEN & JOSEPH FULLER, WHAT’S A DIRECTOR TO DO? (Harv. NOM, Working Paper No. 02-38, Oct. 2002), at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=357722](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=357722) (last visited Apr. 19, 2004) (“The recent wave of corporate scandals provides continuing evidence that boards have failed to fulfill their role as the top-level corporate control mechanism.”). Of course, poor earnings and poor market performance might endanger management by making the corporation a target for a hostile takeover. See Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 265-66 (1977). Yet, takeover defenses, such as poison pills and staggered boards, increasingly have blunted this threat. See Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889 (2002). Moreover, it seems that takeovers result from a sustained period of poor earnings and poor market performance rather than the sort of short-term poor performance addressed by Professors Arya, Clover and Sunder. Arya, *supra* note 64. Cf., Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1497-98 (1989) (noting that large effects on stock price are necessary to trigger a takeover because of the substantial premiums involved).

Higher share prices might provide a second possible benefit to non-selling shareholders if the shareholders use their stock as collateral for loans. This benefit can dissipate, however, if share prices decline in the future (which, as discussed below, is a danger with earnings management). In this event, the loan agreement might require the posting of additional security, as can occur when a decline in stock prices produces a margin call on stock used as collateral for a loan used to finance the purchase of stock. See 12 C.F.R. §§ 221.3, 221.8 (limiting borrowing to buy stock on margin to a percentage of the value of the stock securing the loan).

may end up paying more taxes as a result of seeking higher reported earnings. Admittedly, corporations often are able to avoid this disadvantage insofar as the law allows inconsistent accounting treatment in tax returns and public financial reporting.<sup>67</sup> Nevertheless, a recent study of firms that restated their publicly reported income during the years 1996 to 2002 found these companies paid more than \$300 million in taxes on income they subsequently conceded they did not make.<sup>68</sup>

A second disadvantage for the non-selling shareholders from earnings management is the danger that the corporation may face liability for securities fraud. As noted by Judge Friendly, corporate liability in securities fraud lawsuits effectively means taking money from the existing shareholders of the corporation to pay injured traders.<sup>69</sup> Of course, the court in *Kamin* did not hold that the business judgment rule would protect directors whose efforts at earnings management reached the point of constituting a knowing misrepresentation of material fact. Yet to suggest, as seems to be the bottom line in *Kamin*, that the business judgment rule protects all efforts to manipulate accounting in order to report the largest possible earnings so long as the SEC does not find fraud, underestimates the danger of such a regime from the standpoint of the interest of non-selling shareholders. The problem is that earnings management often operates in a gray area between straightforward reporting and outright fraud.<sup>70</sup> Operating in this gray area creates the risk that the corporation will incur liability if the corporate officials misjudge what a finder of fact later decides was acceptable, or, even without an adjudication of liability, the risk that the corporation will incur the costs of litigation and possibly settlement.<sup>71</sup>

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67. See George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMUL REV. 209 (2001).

68. Merle Erickson et al., *How Much Will Firms Pay for Earnings that Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings* (Oct. 2002), at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=347420](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=347420) (last visited Apr. 19, 2004).

69. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring).

70. See Rowland, *supra* note 12, at 169 n.5 (internal quotations omitted).

71. Amendments to the Securities Exchange Act passed by Congress in 1995 make it easier for corporations to avoid lengthy litigation of securities fraud claims when the merits are uncertain, most particularly by imposing heightened pleading requirements. See, e.g., 15 U.S.C. § 78u-4 (2004); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999) (dismissing a fraud class-action claim for

Since almost all shareholders sell eventually, it is also appropriate to consider the impact of earnings management upon shareholders who sell a significant time after the corporation has reported higher “managed” earnings. Earnings management often has a sort of “robbing-Peter-to-pay-Paul” effect as far as future earnings reports. So, to use a simple example, the crude earnings management technique of seeking at the end of an accounting period to delay expenses and accelerate receipts<sup>72</sup> so as to show higher reported income for the period (be it a year or a quarter), means less income and more expense reported for the next period—presumably to the detriment of shareholders who sell after the next period. Indeed, this “robbing-Peter-to-pay-Paul” aspect of earnings management can create a snowball effect, as illustrated by the recent corporate scandals. Unless real earnings substantially increase, management must use ever more aggressive earnings management techniques just to pull reported earnings out of the hole dug by the prior use of earnings management, not to mention meeting market demands for reporting ever-increasing earnings.<sup>73</sup> The end result in companies like Enron and WorldCom was a collapse of stock prices to the detriment of stockholders who had held their shares and sought to sell too late.<sup>74</sup>

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defective and insufficient pleadings). This, however, does not eliminate all threat of suit. *See* EP Medsystems, Inc. v. EchoCath, Inc., 235 F.3d 865 (3d Cir. 2000) (upholding complaint under Rule 10b-5 as meeting the heightened pleading standard).

72. Managers might accelerate receipts by adopting sales incentives that encourage their customers to move forward purchases that the customers will make anyway (so-called “channel stuffing”). *See* ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON’T WANT YOU TO KNOW 163 (2002).

73. *See, e.g.,* Cunningham, *supra* note 1, at 933-34.

74. *See* Robert Frank et al., *Scandal Scorecard*, WALL ST. J., Oct. 3, 2003, at B1 (detailing stock price declines at Enron and other corporations involved in scandals of 2002).

This discussion of earnings management is oversimplified insofar as it presupposes the use of earnings management always to report the highest possible income for any given accounting period—which creates the “robbing-Peter-to-pay-Paul” problem of simply putting off the Day of Judgment. By contrast, in the technique referred to as a “big bath,” management reports a major one-time loss, instead of gradually reporting increased expenses spread over a period of time in the future. *Id.* The notion is that investors will ignore one-time losses as aberrational. *See* Rowland, *supra* note 12, at 172 n.14. (Interestingly, this view of investor psychology is quite different than taken by the directors and the court in *Kamin*). Moreover, up until the market of the 1990s, it appeared that corporate officials often used earnings management to level out reported income. In other words, corporate officials manipulated accounting to avoid overly good showings in fat



All told, the court in *Kamin* was mistaken in its assumption that the interests of American Express's shareholders justified transactions designed solely to maximize reported earnings. The interests of trading shareholders (buyers and sellers) wash out, and maximizing reported (rather than real) earnings does not generally further the interests of non-trading shareholders.<sup>75</sup> This

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years, as well as to improve reported earnings in lean years. See Coffee, *supra* note 9, at 11. For example, a corporation might lower reported earnings during a particularly good quarter by charging, as an added expense, increased funding of so-called "cookie-cutter reserves." The corporation then could reduce such reserves in order to improve net income reported in a poor quarter. See Rowland, *supra* note 12, at 172 n.14.

A full exploration of the impact of these sorts of techniques on the interests of shareholders is getting a bit beyond the scope of this short essay. To begin with, the impact is subtler than with earnings management that simply seeks to maximize reported earnings. For instance, smoothing reported earnings might improve share prices over the long term because investors discount the price they are willing to pay depending on the volatility of earnings. (Greater volatility means greater risk, which, in turn, leads rational investors to demand a greater return. See FRANKLIN A. GEVURTZ, BUSINESS PLANNING 570-71 (3d ed. 2001)). Moreover, managers might argue that there is no inherent reason why smoothing of reported earnings, and resulting higher share prices, cannot continue indefinitely. The danger, however, arises from the fact that investors are looking at past earnings volatility in order to gauge future risk. So long as future earnings volatility (as massaged through earnings management) does not exceed the past, there is no harm, just as there is no harm to going without fire insurance so long as there is no fire. The comeuppance occurs if the corporation suffers a particularly bad period of earnings. In this event, the stock price presumably will go down, not only to reflect the decreased earnings, but also to reflect a reassessment of the riskiness of holding the stock. This decrease in price obviously harms purchasers who overpaid because earnings management caused them to underestimate the riskiness of the stock. Moreover, having been burned, investors might further discount the stock to reflect the risk that, due to earnings management, they still are misjudging the risk.

Returning our focus to *Kamin*, however, the green light given to earnings management by the court seems to ignore any distinction between smoothing earnings and seeking to maximize earnings. *Kamin*, 383 N.Y.S.2d at 815. In fact, because of the one-time nature of the loss suffered by American Express on the DLJ stock, the goal of maximizing reported earnings may have coincided with the goal of smoothing out fluctuations in reported earnings. Yet, the court never draws any attention either to this fact or to its implications as far as permissible earnings management. *Id.* In any event, the corporate scandals of 2002 seem to have been symptomatic of a shift in the use of earnings management from a device to smooth out reported income, to a device to show ever-growing income. See Coffee, *supra* note 9, at 11.

75. For a different analysis of whether earnings management is in the interests of shareholders (focusing on the investment strategies of so-called "right side" and "left side" shareholders, and finding that earnings management is never in the interest of "right side" shareholders and not in the ultimate interest of "left side" shareholders) see William Bratton, *Shareholder Value, Financial Conservatism,*

does not mean that every accounting choice that results in higher reported earnings than another choice breaches the directors' duty. If the choice does not impose a significant cost on the corporation (such as the \$8 million of tax savings lost in *Kamin*), then the choice represents a functional nil set. This analysis does mean, however, that the desire simply to report (rather than to achieve) higher earnings cannot justify incurring significant costs for the corporation.

### III. CONCLUSION

The purpose of this essay is not to argue that shareholder derivative lawsuits asserting state law fiduciary duty claims are the answer to earnings management. *Kamin* was a fairly rare case in that the directors' efforts to pump up reported earnings entailed an immediate, large, and concrete cost upon the corporation. This substantial negative impact upon the corporation, in turn, forced the directors to be candid about their motive and confronted the court with the need to assess the legitimacy of the directors' goal. The significance of the court's acceptance of the directors' goal lay not in closing off future state law shareholders' derivative claims, since earnings management normally will not impose the sort of cost upon the corporation that would prompt a state law shareholder derivative lawsuit. Rather, the significance of the decision in *Kamin* was the unfortunate message that it sent to future corporate management and their attorneys. To the extent that judicial pronouncements have an impact independent of creating or precluding liability because of the norms such pronouncements establish,<sup>76</sup> then the court's decision in *Kamin* can take some responsibility for the corporate scandals of 2002.

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and *Auditor Independence* (Oct. 10, 2003), at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=454080](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=454080) (last visited Apr. 19, 2004).

76. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1793-95 (2001).