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Comment

Earnings Management as a Professional Responsibility Problem

William H. Simon*

Not infrequently, managers of public companies propose to do things—rearrange their operations, restructure assets and liabilities, sell and buy property—solely for the purpose of achieving accounting effects they desire. Most often they want an increase in current reported earnings per share, though sometimes they prefer a current decrease in the earnings they would otherwise report when it will allow them to show a smoothly increasing pattern of earnings in the future.

Sometimes the desired effects require outright lying or violations of Generally Accepted Accounting Principles (GAAP), in which cases the maneuvers are plainly illegal. But even where they do not involve lying or GAAP violations, "earnings management" activities are at best wasteful and at worst misleading. Why should lawyers assist in them? Why do the bar or the courts not adopt a maxim that, where it appears that a manager's sole or dominant purpose in undertaking an activity is to achieve favorable accounting effects (that is, accounting effects that make management look good), the lawyer has a duty to advise against and refuse to assist it? Another way to frame the principle would be to insist that management articulate a prima facie plausible business purpose for an activity for which it asks the lawyer's assistance.[1]

Although earnings management has come in for a good deal of criticism lately,[2] no one has suggested that lawyers have any duty as broad as this one. Lawyers routinely assist with various kinds of earnings management. So Steven Schwarcz seems to reflect the prevailing assumption among practitioners in arguing that such assistance should not be regarded as presumptively

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1. It might be questioned whether such a duty would have significant practical effects. Perhaps managers would be willing and able to invent minimally plausible business rationales for most of the activities they wished to undertake. On the other hand, perhaps some managers would be deterred simply by the knowledge that they had a duty not to proceed in the absence of a business purpose, and perhaps lawyers would sometimes be able to distinguish patently pretextual purposes from legitimate ones. Without some experience at trying to implement the principle, it is hard to say what its effects would be. The question of effect, however, is relevant only if we accept the prior principle that there is something presumptively wrong with earnings management. So I focus here on that question.

2. *E.g.*, Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street: Putting a Stop to the Earnings Game*, J. APPLIED CORP. FIN., Winter 2002, at 41.

wrongful.[3] Nevertheless, there is a substantial argument that a rule of presumptive prohibition would be most consistent with both the securities laws and the lawyer's fiduciary duty to her corporate client.

Considering the arguments against professional assistance to earnings management may shed some light on Schwarcz's analysis of lawyer opinions in structured-finance and other transactions. This is a pioneering contribution, but it disappoints on precisely the point to which its title draws attention—in delineating the "limits" of the lawyer's discretion to assist the corporate client. We can all agree with Schwarcz that lawyer assistance to transactions involving explicit deception is inappropriate.[4] At the other end of the spectrum, Schwarcz is only slightly more controversial when he argues that a lawyer should not be prohibited from assisting a lawful leveraged buy-out just because it entails loss of jobs.[5] But if we are concerned with "limits," we should focus on activities that are less obviously illegal than the former but more directly implicate the lawyer's expertise and responsibilities than the latter. Earnings management is an especially fruitful example.

Schwarcz's main reason for opposing presumptive prohibition of assistance to earnings management activities is that such activities are not categorically illegal.[6] If we think they are bad, he says, then we should just ban the underlying transactions before limiting lawyers' discretion to assist them.[7] So the "limit of lawyering" turns out to be the law. I find both the premise and the conclusion of this argument more ambiguous and debatable than Schwarcz does. Before we locate the limits of lawyering in the "law," we need to explain what we mean by law, and this requires consideration of some issues that Schwarcz elides. And when we turn to the relevant doctrine, the case for a presumptive prohibition of earnings management, while not beyond debate, seems considerably stronger than Schwarcz allows. I consider these points in turn.

I. Two Concepts of Law

Schwarcz's article invokes the idea of law in at least two distinct senses. One is purposive or functional; one is positivist or predictive. Each has different implications for the limits of lawyering.

The purposive or functional conception underlies Schwarcz's conditions for third-party opinions: The lawyer should demand reasonable substantiation of the factual premises on which he has been asked to opine.[8] If the transaction as a whole is complex, he should not be obliged to

3. Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEXAS L. REV. 1, 3 (2005).

4. *Id.* at 5–6.

5. *Id.* at 28.

6. *Id.* at 27–28, 31–32.

7. *Id.* at 32.

8. *Id.* at 18 n.98.

investigate all its aspects.[9] He should, however, follow up with respect to "red flags" that signal the possibility of illegality.[10] In cases of doubt, he may ask inside counsel for an opinion that the transaction as a whole conforms to law; a refusal to give such an opinion, unaccompanied by a persuasive reason, is a strong indication that the lawyer should not assist.[11] In any event, where it is clear that the transaction involves illegality, the lawyer should not give the requested opinion, even if, considered alone, it would be accurate.[12]

How does Schwarcz derive these principles? He cites no specific statutory or case law support for them. His most pertinent cites are from reports of bar associations that have no formal lawmaking power, but which have given extensive (and in some respects, disinterested) consideration to the matter. He also invokes the general social goal of economic efficiency, and specifically, the rcduction of information asymmetries. And he implies that his precepts would complement a variety of legal rules that govern structured-finance transactions, for example, bankruptcy, contract, and securities law, by inducing practice likely to effectuate their purposes of promoting mutually beneficial collaboration and exchange.

Thus, Schwarcz's framework derives its plausibility from (a) its consistency with the views of informed practitioners, (b) its tendency to further the underlying purposes of a variety of laws, and (c) its harmony with the basic social value of economic efficiency.

To be sure, it might be possible for Schwarcz to argue that his precepts are supported by law in a narrower sense. He could point to court cases holding lawyers liable for failing, for example, to do "due diligence" with respect to some factual premise of an opinion. Many of these cases, however, would lead us back to a more informal conception of law grounded in social practices and values. Much professional liability is premised on standards of practice developed within professional communities. These standards become law in the narrow sense when they are incorporated by some liability norm, such as the duty of care, but this happens only after and because they have been recognized as binding in informal social processes.

The narrower conception of law appears most clearly in Schwarcz's article when he discusses the kinds of concerns that should require a lawyer to refuse to assist in a transaction.[13] Schwarcz wants to limit his prohibition to transactions involving illegality, with the term now understood in a positivist, predictive sensc.[14] From this perspective, the legality of a transaction turns on the likelihood that a state institution with jurisdiction

9. *Id.* at 18.
10. *Id.* at 17.
11. *Id.* at 33–44.
12. *Id.* at 33.
13. *Id.* at 33–34.
14. *Id.* at 41.

over the matter will or would prohibit it. Because he does not consider it illegal in this positivist sense, Schwarcz does not regard earnings management as presumptively suspect. Under this second narrow conception of law, it is not important (a) that the practice is inconsistent with the considered judgments of informed practitioners, (b) that it frustrates the underlying purposes of relevant surrounding law, or (c) that it is economically inefficient.

As a guide to professional practice, this second conception of law has some critical ambiguities. Let me mention just two. First, it is not clear what the relevant prediction is. Are we supposed to predict whether a state institution will actually prohibit the practice, or whether a state institution would prohibit it if it had the opportunity to review it? The likelihood of actual prohibition depends in part on such matters as whether the conduct is ever discovered and whether those with standing to challenge it have the resources to do so. Many would consider these factors irrelevant to the legality of the conduct, but some lawyers see no problem in taking advantage of them. Some tax lawyers, for example, think it is legitimate to take advantage of the IRS's limited enforcement resources to play the "audit lottery."[15]

Second, how reliable or specific does the prediction have to be before a prohibition is binding? Does there have to be a rule or case with a prohibition that describes the exact conduct in question? Or is it enough that the relevant authority prohibits analogous conduct or lays down general principles that apply to our case? The *reductio ad absurdem* of the former position is the argument of a few criminal defense lawyers that their duty of respect for law requires them to comply with the Internal Revenue Code requirement that they report large cash payments from their clients only if and when they are individually ordered to do so by a court.[16]

An only slightly less extreme version of this perspective is the claim of the Kaye, Scholer firm, repeated here by Schwarcz, that the charges of misconduct by the Office of Thrift Supervision arising from the firm's representation of Lincoln Savings & Loan in the 1980s represented "retroactive" lawmaking.[17] In fact, most of the charges were applications of long-established tort principles to a situation that, while novel in some respects, involved precisely the kind of social stakes the principles were designed to protect.[18]

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15. *See* John D. Dorocak, *Potential Penalties and Ethical Problems of a Filing Position: Not Reporting Gain on the Expiration of a SCIN After* Estate of Frane v. Commissioner, 23 U. DAYTON L. REV. 217, 245 (1998) (concluding that it is within the legal rules of ethics for a lawyer to discuss the "audit lottery" with a client).

16. Fred Strasser, *Lawyers Must Name Names*, NAT'L L. J., June 24, 1991, at 18.

17. Schwarcz, *supra* note 3, at 39–40.

18. My analysis of the charges concludes:

> At least with respect to the duty-of-candor claims, what was new in the Lincoln case was not the principles but the circumstances. Those who speak about the novelty of OTS's approach do not point to past bank failures of comparable magnitude involving

The more the positivist allows for the influence of hypothetical decisions as well as actual ones, and the more she is willing to predict from analogy and principle as well as from fully specific rules and cases, the more this second conception of law blurs with the first, purposivist one.

When he posits a potentially large gulf between law and informal norms, Schwarcz adopts a relatively narrow, predictive understanding of law;[19] one that contemplates that "technical" compliance with disclosure norms might be sufficient even when there is a likelihood that a report will be misunderstood. Schwarcz is attracted to this narrower conception because it promises greater certainty about what one's obligations are.[20] It is questionable whether lawyers need this kind of certainty. If social norms are sufficiently developed and appreciated, they should support predictable judgments. On one conception, making complex judgments from diverse types of authority represents the most distinctive and valuable lawyering skill. (The duty of care to clients in malpractice cases is measured basically in terms of informal norms.) Moreover, whatever certainty the narrow conception of predictive legality would provide lawyers is likely to come at the cost of reduced certainty for investors. If we are concerned about predictability for investors, the most pertinent norms are those that track investors' expectations, and these will most likely be a mix of formal legal and informal social norms.[21]

In addition, the gap between legal duty and informal social norms that the positivist conception tolerates could mean that lawyers will more often participate in conduct that will widely be regarded as socially harmful. It will very likely mean that they will more often participate in conduct that they themselves would regard, were they encouraged to make a judgment on

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> similar conduct in which lawyers were treated more leniently. There was nothing radical about the notion that lawyers ought not to assist fraud. What was new . . . was the banking system's vulnerability to fraud.

William H. Simon, *The Kaye Scholer Affair: The Lawyer's Duty of Candor and the Bar's Temptations of Evasion and Apology*, 23 LAW & SOC. INQUIRY 243, 269 (1998). For analysis of the charges, see *id.* at 246–58, 283–95.

19. *See* Schwarcz, *supra* note 3, at 36–37 (discussing the disconnects between positive law and social norms).

20. *Id.* at 39 (concluding that the codification of changing norms into retroactive law undermines "the certainty and objectivity needed to structure transactions").

21. Here I follow the past century's most uncompromising proponent of legal predictability:

> [T]he belief that everyone must be able to foresee the consequences that will follow in an unforeseen factual situation from an application [of the formal law] is clearly an illusion. . . . What has been promulgated or announced beforehand will often be only a very imperfect formulation of principles which people can better honour in action than express in words. Only if one believes that all law is an expression of the will of a legislator and has been invented by him, rather than an expression of the principles required by the exigencies of a going order, does it seem that previous announcement is an indispensable condition of knowledge of the law.

1 FRIEDRICH A. HAYEK, LAW, LEGISLATION, AND LIBERTY: RULES AND ORDER 117–18 (1973).

the matter, as socially harmful. This could damage both their perceived public legitimacy and their sense of self-respect.

Judge Friendly seemed to have some such notion in mind when he rejccted the narrow conception of legal duty in the securities fraud case of *United States v. Benjamin*.[22] Charged with fraud, the accountant defendant responded that his "pro forma" financial statements were literally accurate because they only purported to characterize information provided by the defendant and he did not know the information was false.[23] Under these circumstances, he argued, there could be no fraud liability.[24] Citing neither statutes nor cases, but rather finance and accounting manuals, Judge Friendly responded that the fraud norms of the securities statutes should be interpreted in the light of the considered practices of the accounting profession, which requircd some efforts to verify statements of this kind.[25] To hold otherwise, he said, "would be insulting an honorable profession."[26]

II. Two Objections to Earnings Management

We can concede that, in the narrow, predictive view, earnings management is not categorically prohibited. (Of course, predictive judgments are probabilistic. So when we say not prohibited, we mean only that the probability seems Iow that this is how the court would rule.) On a purposive view, however, legality turns not simply on our prediction about how a court would rule but on our judgment about how it ought to rule. From this point of view, earnings management seems of doubtful legitimacy on two grounds. It seems inconsistent with (a) the principles underlying the securities disclosure rules, and (b) the fiduciary duties of both lawyers and management to the organization.

The intuition that there is something presumptively wrong with earnings management under the securities laws is straightforward. Investors are likely to interpret changes in a corporation's reported accounting measures as indicators of changes in its business operations. These figures are mandated in order to guide investment decisions.[27] They are produced by auditors ostensibly independent of management for the purpose of "fairly and accurately" reflecting the business condition of the company. An accounting practice of basing reported earnings on business operations undertaken independently of accounting effects is more consistent with the expectations this

22. 328 F.2d 854 (2d Cir. 1964).

23. *Id.* at 860.

24. *Id.*

25. *Id.* at 861.

26. *Id.*

27. *See* Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 713 (5th Cir. 1984) (holding that the purpose of securities disclosure provisions "is not to tip the scales in favor of management or its opponents but to insure that a public shareholder, confronted by a cash tender for his stock, can obtain adequate information about the qualifications and intentions of the offering party before responding to the offer").

situation encourages than one that permits management to affect reported numbers through activities that have no business purpose.

The manager who proposes the earnings management transaction may believe that the accounting effect he is striving to produce would better reflect the financial condition of the company than the numbers that would be generated without the transaction, but he will usually have a strong bias that should lead us to doubt his judgment on the matter. It is also true that, if earnings management is permitted and investors know that it is, they will expect it and will discount earnings figures accordingly. This practice, however, is likely to be overbroad and socially inefficient. Since investors don't know who is engaging in the practice, they will discount stocks of companies that do not engage in it as well as those that do. Moreover, from the point of view of fairness to investors, excusing deceptive manipulation on the ground that investors expect it is like saying that a mugging victim "was asking for it" because he went walking in a questionable part of town.

Schwarcz suggests that financial statement figures are the responsibility of accountants, and that if the auditor has no objection to management's maneuver, the lawyer should have no responsibility to make a further judgment before proeeeding to assist.[28] As Schwarcz recognizes, however, this advice cannot apply where the accounting standards themselves require lawyers to make judgments as a precondition of a certain treatment. Enron is a notable example. The standard applicable to special purpose entities conditioned off-balance-sheet treatment of debt on a lawyers' opinion that the transaction was a "true sale."[29]

Moreover, although the point seems to have been forgotten during the boom of the 1990s, compliance with GAAP does not excuse otherwise misleading reporting.[30] Even where lawyer deference to auditor judgments about GAAP requirements would make sense, deference to judgments about what is misleading might not. In the category of cases we are talking about, the absence of "business purpose" is a red flag that requires no great expertise to recognize.

Aside from the securities laws, both lawyer and manager have a fiduciary duty under state law to the corporation. This duty embraces the shareholders' interest in accurate financial reporting. Fiduciary standards are generally more exacting than conventional legal duties. Thus, assuming that a substantial range of earnings management is permitted by the securities

28. *See* Schwarcz, *supra* note 3, at 47 ("In contrast to an aecountant whose responsibility is to fairly present financial statements, the opining lawyer's sole duty is to present an accurate, fair, and objective opinion on thc legal matters the opinion covers.").

29. *Id.* at 2 n.8; *see generally* ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENT OF LIABILITIES, Statement of Fin. Accounting Standards No. 140 (Fin. Accounting Standards Bd. 2000) (stating the rules on off-balance-sheet transactions at the time of the later Enron deals).

30. United States v. Simon, 425 F.2d 796, 806–07 (2d Cir. 1969); THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 610–11 (4th ed. 2002).

laws, it might still be inconsistent with corporate fiduciary duty. If financial reporting without earnings management better serves shareholder interests, then fiduciaries should forgo these practices.

Schwarcz's answer to this claim seems to deny that shareholders have an interest in the most accurate possible financial reporting. In an interesting related article, he argues that, under state corporation law, fiduciary duties embrace the interests of current shareholders, not future shareholders.[31] Current shareholders are prospective sellers, and as such do not have an interest in the disclosure of information that would lower the stock price.[32] If earnings management pumps up the stock price, that is in the interests of current shareholders. On this view, more active fraud would also be in the interests of shareholders, but that is forbidden by securities and tort law. Schwarcz's point is that fiduciary duty does not do any additional work in the financial reporting area and should not be interpreted to expand disclosure duties.

The argument is ingenious, but I find it unconvincing. In the first place, Schwarcz's claim that state law does not include the interests of prospective shareholders within the ambit of corporate fiduciary duties is debatable. The relevant authority is skimpy, sometimes ambiguous, and does not specifically address the issues we are considering. It would be more accurate to say that state law leaves the matter open.[33]

Second, even if fiduciary duty only embraces current shareholder interests, it seems unlikely that those interests are consistent with earnings management. Short-term shareholders may get a better price because of its cosmetic effects, but long-term shareholders are likely to suffer if the practice is detected and the firm's reputation for accurate reporting is compromised.

More importantly, all current shareholders have a stake in the corporation's mechanisms of managerial accountability, and financial reporting plays a crucial role in these mechanisms. Giving managers

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31. Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044, 1049 (2005) ("Corporation law suggests the audience should be current investors. Directors and management, at least in the United States, have a fiduciary duty only to investors holding an existing property right or equitable interest to support such a duty—i.e., current investors.").

32. *Id.* ("[L]ess prominent disclosure of risk . . . helps current investors preserve the value of their investments.").

33. There is some support for the notion that a corporation has a duty to disclose information distinctively relevant to prospective shareholders in *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947), and its sequel, *Speed v. Transamerica Corp.*, 135 F. Supp. 176, 186–94 (D. Del. 1955), *modified*, 235 F.2d 369 (3d Cir. 1956). These cases hold that, while the corporation did not owe a duty to holders of convertible preferred shares that would require the corporation to forgo exercising a contractual redemption privilege, it did have a duty to disclose information helpful to the holders in deciding whether to exercise their conversion privilege, even though such disclosure was not contractually required and was disadvantageous to the common shareholders.

discretion over financial reporting issues is like allowing students to grade their own tests.

III. Conclusion

The "limits of lawyering" are the constraints of law, but having said that, the question remains—what do we mean by law? If we take a narrow, predictive conception of law, the limits will be less restrictive than if we take a broader, purposive view. Schwarcz's analysis seems inconsistent. He implies a broader conception of legality in prescribing due-diligence principles for lawyers, but he then veers toward a narrower one in arguing for discretion to assist conduct that violates the spirit but not the clear terms of the securities laws.

Earnings management practice is a good test of the difference between the two conceptions. Sehwarcz's argument that there is nothing presumptively wrong with it rests on the narrower conception. On a more ambitious conception of legality, earnings management should be viewed as presumptively wrong. The more ambitious conception is most compatible with the idea of lawyering as a diguified calling.