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August 8, 2008

BY ELECTRONIC MAIL

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LETTER OF COMMENT NO. 179

Re: Proposed Statement of Financial Accounting Standards – Disclosure of
Certain Loss Contingencies (File No. 1600-100)

Dear Mr. Golden:

We are submitting this letter in response to the request of the Financial Accounting Standards Board (the "FASB") for comment on the FASB's proposed statement of financial accounting standards relating to disclosure of certain loss contingencies (the "Proposed Standard").¹

Providing financial statement users with meaningful information to enable them to better assess the potential timing and impact of loss contingencies is an important objective, and there may be room for improvement in this area of financial reporting. On the other hand, requiring additional disclosures about loss contingencies presents serious risks, including (a) the risk that there will be no reasonable basis for providing the required information, and consequently that the disclosure will be inaccurate or unfounded, (b) the risk that preparing the information will be difficult and costly, (c) the danger that the review and audit of the information will raise serious issues that adversely affect the relationship between the legal and auditing professions (and the companies that engage them), to the detriment not only of those companies but also their investors, (d) the likelihood that disclosures will be prejudicial to the issuer in the context of a particular litigation, notably by entailing the loss of privilege, and (e)

¹ Exposure Draft, Proposed Statement of Financial Accounting Standards – Disclosure of Certain Loss Contingencies, File Reference No. 1600-100 (June 5, 2008) (the "Exposure Draft").

the prospect that new disclosure requirements will create opportunities for new forms of destructive gamesmanship by counsel for parties and potential parties adverse to the issuer.

We believe the Proposed Standard presents all these risks, and the potential consequences would be likely to be seriously adverse to companies and to investors, particularly long-term investors, in those companies. We also believe the case has not been made that there is the kind of extraordinary need for change that would justify incurring these substantial risks.² Accordingly, we recommend that the Proposed Standard not be adopted and that the FASB and the Securities and Exchange Commission (the “SEC”) jointly undertake to study the issue of loss contingency disclosures to determine whether improvements can be made without imposing the significant systemic costs that would result from adopting the Proposed Standard.

Against that backdrop, we have the following specific comments on the Proposed Standard:

1. The FASB should not require a company to make estimates of matters that are not reasonably estimable.

We agree with the observation in the Exposure Draft that the option under current disclosure standards to state that “an estimate of the possible loss or range of loss cannot be made” is exercised with considerable frequency, and we acknowledge that the absence of estimates often makes it difficult for financial statement users to assess the possible future cash flows associated with contingencies.

We believe, however, there are good reasons for this state of affairs. Providing an unreliable quantitative estimate that has no reasonable basis does not meaningfully assist investors in understanding the risks posed by a particular contingency, and such an estimate can expose a company to significant further litigation exposure if the actual loss differs materially from the estimated amount. Estimating the potential loss or range of loss from pending litigation often is an inherently difficult exercise, particularly during the early stages of litigation when discovery is not yet complete. The vast majority of cases are resolved by settlement, based on negotiations that are unpredictable and depend on a wide range of factors including some that are unrelated to the merits of the case. Against that backdrop, FAS 5 sensibly permits a company that concludes it cannot make a reasonable estimate to provide a statement to that effect in lieu of providing an uncertain and unreliable estimate.

In its basis for conclusions, the Exposure Draft asserts that financial statement users “prefer to have a highly uncertain estimate supplemented with a qualitative description than no quantification of a potential loss as commonly occurs in existing practice.” This proposition is highly debatable – financial statement users often are existing investors in a company and might well prefer disclosure that does not impair a company’s ability to minimize (or avoid entirely) litigation exposure. Our concern is heightened by the fact that

² Although probably not susceptible to empirical verification, we do not believe investors in fact generally are caught off guard when companies announce large litigation or regulatory settlements. Our review of case law and SEC proceedings reveals a dearth of situations where investors were sufficiently surprised by adverse developments in litigation or regulatory investigations that they (or the SEC) brought claims under Rule 10b-5 or, in the case of the SEC only, Rule 12b-20, each of which relates to material misstatements or omissions.

these potentially “highly uncertain” estimates will not benefit from the safe harbor for forward looking statements set forth in the Private Securities Litigation Reform Act, which does not extend its protections to financial statement disclosures required under GAAP.

At bottom, the Proposed Standard, by abandoning the option in FAS 5 to state that a reasonable estimate cannot be made, will in many cases require companies to incur significant expense and additional litigation exposure to develop estimates that, in view of their limited reliability and uncertain relationship to the final amount of a loss, are unlikely to provide financial statement users with meaningful information about the potential financial impact of the litigation. We believe the FASB has not adequately justified this radical change in approach.³

2. The FASB should not require a company to estimate the maximum possible loss from a matter for which no claim or assessment has been made.

Under the Proposed Standard, it will frequently be necessary for issuers to estimate the maximum possible loss from a claim. Plaintiffs often do not specify an amount of money damages in a complaint, and in many jurisdictions they are prohibited from doing so, or are permitted to state only that the amount claimed exceeds the relevant jurisdictional threshold. Similarly, regulatory investigations frequently are unaccompanied by an indication of the amount or nature of relief that will be sought. Against this backdrop, it is likely that the Proposed Standard, if adopted as proposed, would require estimates of maximum possible loss in a significant number of cases.

Estimating the maximum possible loss from a potential contingency promises to be a highly difficult exercise, particularly during the early stages of litigation, when the facts and legal analysis of the case are not yet fully developed. There may be no reasonable basis for doing so. Moreover, a company’s assessment of the maximum possible loss likely will be used against it in litigation, can be expected to complicate settlement discussions and in many cases may lead to higher judgments or settlement amounts. To reduce the informational advantage this disclosure will provide to adversaries in litigation or prospective litigation, a company may be expected to err on the low side when making its estimate. Yet doing so will expose the company to further litigation if the actual amount of the charge differs materially from the estimated amount.

Similarly, we do not believe a company should be encouraged or required to provide information about its best estimate of the loss or range of loss. Although the Proposed Standard would not make disclosure of a company’s best estimate of its anticipated loss (or range of loss) mandatory, in practice a company operating under the new standard may feel compelled to disclose its estimate to place the maximum possible loss in context, particularly when that maximum loss itself is an estimate because there is no stated claim or assessment. Providing this information is problematic for several reasons. First, a company that discloses such information may inadvertently create a floor for any potential settlement, jeopardizing its

³ It is instructive that as recently as its adoption in June 2006 of FASB Interpretation No. 48 (“FIN 48”) the FASB has reaffirmed the appropriate balance struck by allowing a company to state that an estimate of this sort cannot be made.

ability to obtain a favorable outcome. Second, the estimate may be wrong, which could expose the company to litigation risk.

3. A company should not be required to publicly disclose its qualitative assessment of the most likely outcome of a legal proceeding, the factors it believes likely to affect the ultimate outcome of a contingency and their relative weight, the significant assumptions underlying its estimates or its expectations regarding the timing of resolution of the contingency.

The FASB should not adopt the proposed requirement in paragraph 7.b of the Proposed Standard that a company publicly disclose its qualitative assessment of the most likely outcome of the contingency, a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome, significant assumptions made in making its estimates, or the expected timing of resolution.⁴

Assessment of the likely outcome of litigation depends on myriad factors, many of which are uncertain or ill suited to public disclosure. A requirement to describe the factors that could influence the outcome of a claim and their relative weights could require a company to disclose, for example, its analysis of potentially damaging documents or testimony, its views of the judge or jury pool, its assessment of the strength of available defenses to the merits and the availability of class certification or its assessment of counsel involved in the proceeding. Requiring disclosure of these or similar matters would provide a roadmap to a company's adversaries that would almost certainly prejudice a company's litigation posture. Again, this prejudice would outweigh any benefits to investors. In many cases, it would also result in a damaging waiver of otherwise available privileges for attorney work product and attorney-client communications. Waivers would produce discovery requests for attorney-client communications and expert reports underlying the disclosure, requiring a company to disclose strategically important documents to its adversaries that would otherwise be privileged. Similarly, requiring a company to disclose its assessment of the likely outcome of a claim could require it to make admissions against interest inconsistent with its litigation posture.

The harm to a company's litigation posture would be compounded by the requirement to update its assessment each time financial statements are prepared. A company's views of the outcome of litigation and the factors likely to influence the outcome evolve continually during the course of a proceeding. Although we appreciate the value of updated disclosure that facilitates assessment of loss contingencies, this frequent updating requirement is unlikely to provide that benefit. Instead, the Proposed Standard would require a company, in effect, to provide a running commentary on its properly privileged views of the case.

Similarly, requiring a company to publicly disclose its expectations regarding the timing of a matter's resolution may adversely affect its litigation posture by creating artificial deadlines for resolving claims that can be exploited by a company's adversaries in the litigation process. Moreover, the timing of resolution of a claim typically is difficult to predict

⁴ It is again instructive to compare the disclosures required by FIN 48, which are descriptive of what tax authorities are challenging but do not call for a company to express a qualitative judgment about those challenges.

with reliability, because it depends on multiple factors, many of which are beyond the company's control.

4. The proposed exception for near-term "severe impact" contingencies should not be adopted.

Under paragraph 6 of the Proposed Standard, a company would be required to disclose detailed information about any contingency that is expected to be resolved within the next year, and could have a "severe impact" on the company's financial position, cash flows or results of operations. Disclosure would be required regardless of the likelihood of loss, regardless of whether the claim has been asserted, and regardless of the likelihood of assertion. This would require companies to provide significant disclosure about cases the company is virtually certain to win, and that, because the loss contingencies involved are remote, are immaterial and of little interest to a reasonable investor. The FASB should not adopt this requirement.

For unasserted claims, the disclosures the new exception would require would be not merely unnecessary but also extremely prejudicial to a company. Under the Proposed Standard, if a company believes that an unasserted claim could, if asserted and resolved against the company, have a "severe impact" and be resolved within the next year, disclosure would be required even if there is no expectation of a claim because the potential claimant has evidenced no awareness of it and even if the likelihood of an adverse outcome is remote. Such disclosure could expose a company to a heightened risk of frivolous litigation by highlighting unasserted claims that may have a low probability of success, but nonetheless might have some settlement value (even nuisance settlement value). Similarly, where one of the company's reasons for concluding resolution within the next year is likely is that the statute of limitations for an unasserted claim will run within that year, requiring disclosure of the contingency and the company's analysis could jeopardize the potential statute of limitations defense by reminding potential claimants of the need to bring suit to preserve their rights.

The Proposed Standard appears to be based on a belief that at some level of impact, disclosure should be required no matter how remote the likelihood. This would represent a radical departure from the generally accepted methodology for assessing materiality, which takes into account both the likelihood of an event and the impact of the event.⁵ Taken as a whole, the proposed exception would require disclosure of matters that by definition are not material, while exposing a company to increased litigation exposure. The benefits from the proposed exception are meager, and the cost to companies will in many cases prove significant. The proposed exception should not be adopted.⁶

⁵ See e.g., Basic, Inc. v. Levinson, 485 U.S. 238 (1988) ("with respect to contingent or speculative information or events . . . materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event . . . '"), citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

⁶ We also note that IAS 37, as proposed, has no such exception. Abandoning the proposed exemption thus also would serve the goal of convergence between IFRS and US GAAP.

5. The proposed exception for prejudicial disclosure should be revised to eliminate the proposed mandatory minimum disclosure and to remove the suggestion that it be used “rarely.”

We agree that for pending or threatened litigation, disclosure of certain information about the contingency may be prejudicial to a company’s position, and support the proposal in paragraph 11 of the Proposed Standard to provide an exception that would permit a company, when aggregation is insufficient to eliminate the prejudice, to omit the prejudicial information from its disclosure.

The Proposed Standard makes certain disclosures mandatory regardless of the potential prejudice they may cause or whether the prejudice can be avoided through aggregation. The FASB should not adopt this approach. If disclosure of such matters would be prejudicial to a company, a company should be permitted to omit the disclosure. If the minimum disclosure requirements are retained, they will significantly reduce the utility of the exception for prejudicial information, and in many cases render it largely useless as a practical matter, because the minimum disclosure required more often than not will include the very information that is prejudicial.

We disagree with the FASB’s assessment that the cases in which aggregation will be insufficient to avoid prejudicial disclosure under the Proposed Standard will be “rare.” Indeed, we are concerned that aggregation will often be inadequate protection.⁷ Where a company is involved in a single legal dispute, for example, aggregation will be impossible. Even when aggregated with one or more smaller claims, it will often be evident that a particular claim accounts for the bulk of an aggregated provision. Moreover, the detailed description of the legal and factual background of a contingency and the factors likely to affect the ultimate outcome are matters that are inherently case specific, which makes the required information ill-suited to aggregation. Notwithstanding the guidance in footnote 3 of the Proposed Standard, we believe auditors likely will interpret the term “rare” to permit a company to omit prejudicial information only in an overly narrow set of circumstances. If a company is unable to avoid disclosure of the prejudicial information via aggregation, the exemption should apply, without regard to how frequently the exception is used by the company or others. The FASB should remove the “rare instances” language from paragraph 11.

⁷ Respondents to the proposed FIN 48 argued that the aggregated disclosure required by the proposed interpretation would inappropriately provide a “roadmap” for taxing authorities. FIN 48 ¶ B64. The FASB rejected this argument for two relevant reasons. First, it did not equate a taxing authority with counterparties in a lawsuit because, instead of acting in its own interest, a taxing authority acts in the broader public interest. *Id.* Second, the FASB concluded that disclosures at an aggregate level do not reveal specific information about tax positions while still providing information valuable to users of financial statements. *Id.* It is plain that the first rationale would not apply to the Proposed Standard, but in fact the second is likely to be inapposite as well. Because of both the substantially greater disclosure required by the Proposed Standard and the greater likelihood as a practical matter that there will be fewer and more disproportionately sized matters in the context of the Proposed Standard, the aggregation approach is much more likely to be prejudicially revelatory in the Proposed Standard.

6. The Proposed Standard should not be adopted unless necessary changes to the "Treaty" on audit response letters have been made.

The Proposed Standard should not be adopted unless necessary changes have been made to the "Treaty" between the American Bar Association and the AICPA that governs lawyers' responses to auditors' inquiries. A company's auditors undoubtedly will request additional documentation to support a company's disclosures under the standard.⁸ To the extent the principal support for such disclosures lies in privileged advice from counsel, a company may be unable to furnish that advice to its auditors without risking the waiver of privilege. Absent new guidance from the FASB and PCAOB, auditor requests for information from counsel in connection with efforts to audit the increased disclosures will almost certainly extend beyond the limited disclosure agreed in the Treaty. Absent amendments to the Treaty, a company faced with inquiries from its auditors may be compelled to waive privilege and require counsel to respond to such inquiries in order to avoid a qualified audit opinion. We believe the Treaty has been reasonably successful in accommodating these interests, and any change in accounting standards that could affect its operation should be undertaken with great care and upon consultation with the auditing and legal professions.

7. The FASB and the SEC should jointly undertake to study disclosures under current FAS 5 and propose changes, if needed.

Given the important public policy considerations raised by the Proposed Standard, we suggest that the FASB work with the SEC to jointly appoint an advisory committee to study the issue of loss contingency disclosures. This committee should include representatives of users of financial statements, preparers, the accounting profession, and the legal profession.

* * *

We appreciate this opportunity to provide you with our thoughts on the Exposure Draft. We would be pleased to respond to any inquiries regarding this letter or our views on the Exposure Draft more generally. Please contact Leslie N. Silverman, Alan L. Beller, Giovanni P. Prezioso, or Nicolas Grabar at (212) 225-2000.

Very truly yours,

CLEARY GOTTlieb STEEN & HAMILTON LLP

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⁸ The PCAOB has criticized auditors for failure to review letters of counsel in connection with audits involving loss contingencies. See e.g., PCAOB, Report on 2003 Limited Inspection of Deloitte & Touche LLP (Aug. 26, 2004) at 19-20; PCAOB, Report on 2003 Limited Inspection of KPMG LLP (Aug. 26, 2004) at 19, n.4.