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LETTER OF COMMENT NO. 190

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Request for Comments on the Exposure Draft for a proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies—an amendment of FASB Statements No. 5 and 141(R)*

Dear Sirs and Madams:

We are writing to comment on the FASB's Exposure Draft for a proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies—an amendment of FASB Statements No. 5 and 141(R)* (the "Exposure Draft"), specifically as it relates to contingencies arising out of litigation and other legal claims. While we generally applaud and support the FASB's efforts to improve financial reporting for the benefit of investors and other end-users of financial statements, we believe the Exposure Draft's proposed amendments do not provide actual benefits to investors and other users of financial statements and indeed call for the creation of disclosures that would likely be inaccurate and misleading. This information would therefore be inherently unreliable and unhelpful to investors. For the reasons discussed below, we urge the FASB not to adopt the amendments proposed in the Exposure Draft.

THE POTENTIAL RESULTS OF LITIGATION FREQUENTLY ARE UNPREDICTABLE; REQUIRING ISSUERS TO QUANTIFY THESE CLAIMS WILL NOT RESULT IN RELIABLE FORWARD-LOOKING DISCLOSURES.

We believe that mandatory quantification of loss contingencies will result in the disclosure of estimates that are unreliable and therefore unresponsive to the needs of investors. In March 1975, the FASB adopted Statement of Financial Accounting Standards, No. 5, *Accounting for Contingencies* ("SFAS 5"). SFAS 5 requires accrual and disclosure for an estimated loss from a loss contingency if two conditions are met:

(a) it is probable that a liability had been incurred at the date of the financial statements and (b) the amount of loss can be reasonably estimated. [SFAS 5, paragraph 8.] Moreover, disclosure, but not accrual, is also required if there is at least a reasonable possibility that a loss may have been incurred. [SFAS 5, paragraph 10.]

The Exposure Draft suggests that paragraph 8(b) of SFAS 5—requiring quantification of a proposed loss only if the amount can be reasonably estimated—has resulted in issuers failing to quantify loss contingencies “with such frequency . . . that users [of financial statements] often have no basis for assessing an entity’s possible future cash flows associated with loss contingencies”. [Exposure Draft, paragraph A3(c)] To address this perceived deficiency, the FASB now proposes to require that a company quantify the potential loss attributable to any potential claim that is more than remote. We respectfully submit that this proposal contradicts well-developed financial reporting principles and, while undoubtedly well-intentioned, ignores the basic fact that many—if not most—legal controversies simply are not susceptible of accurate quantification prior to their final disposition.

As the FASB stated in its exposure draft preceding the adoption of SFAS 5, “liability definitions . . . generally require that the amount of an economic obligation be known or susceptible of reasonable estimation before it is recorded as a liability”. [Exposure Draft, Proposed Statement of Financial Accounting Standards, *Accounting for Contingencies*, October 21, 1974, paragraph 38.] We are unaware of any developments in financial reporting that would suggest this basic principle should no longer apply, and we accordingly urge the FASB to maintain its current framework.

Litigation always has been inherently uncertain. The FASB recognized this uncertainty in 1975 by permitting issuers to avoid quantification of loss contingencies when it would be mere guesswork. In our view, litigation has only become more complex and uncertain since 1975. Various matters not connected with the substance of a claim itself—for example, questions of choice of law; statutes of limitation; venue; class certification; evidence admissibility; or evolving case law and precedents—can have a very real effect on the resolution of a legal claim. In addition, even claims of no legal merit frequently are settled by defendants to minimize attorneys’ fees and eliminate the risk of an aberrational jury decision. Moreover, many claims today are of a “kitchen sink” variety. Plaintiffs sue every party even remotely associated with alleged events of loss; claims are purported to be brought on behalf of “nationwide” or “worldwide” classes of plaintiffs and novel legal theories are asserted to expand damages claims. We believe that abandoning the principle that a potential loss must be reasonably estimable before quantification is required will require issuers of financial statements to either (1) close their eyes and guess when formulating loss contingency disclosure or (2) disclose a range of potential losses that is so broad as to be meaningless. Disclosure based on guesswork will not enhance financial reporting; nor will statements that a claim could result in no loss or a multi-billion dollar loss.¹

¹ Moreover, in our current legal system following the Sarbanes-Oxley Act of 2002, senior executives at public companies face considerable personal risk, including potential criminal as well as civil liability, based on their certifications to the company’s periodic reports, including, among other things, the accuracy of the company’s financial statements. In this regard, we note that the “safe harbors” for forward-looking

Even if a company were able to provide a good faith estimate of a loss contingency at a given point in time, the anticipated outcome of a claim changes constantly prior to its final resolution. We believe that requiring companies to disclose a snapshot of a loss contingency at the outset of a legal claim and then periodically update that estimate to take into account these various changes—while eminently reasonable in theory—will in fact foster a body of disclosure that will be unreliable, burdensome in its bulk, and potentially misleading in its volatility. Constant reevaluations and quantification updates would provide no real benefit to investors and other end-users (and could potentially be affirmatively harmful given their risk of being misleading). Our concern is well expressed by the Chicago Bar Association in its comment letter on the Exposure Draft, which states that “quantitative assessments of threatened or pending matters would frequently provide a false sense of comfort or unduly alarm users of financial statements”. We believe that, if the proposed rule is adopted, within a relatively short time it will be clear that most of the resulting quantitative disclosure of loss contingencies is inaccurate or presented with such a broad range as to be meaningless. Under either circumstance, investors and therefore our capital markets as a whole will be harmed by the proliferation of unreliable disclosures with respect to loss contingencies.

**IF ADOPTED, THE DISCLOSURES REQUIRED BY THE EXPOSURE DRAFT
COULD PREJUDICE THE OUTCOME OF LITIGATION AND THUS
ADVERSELY AFFECT THE INTERESTS OF SHAREHOLDERS**

Quantitative disclosures.

The Exposure Draft would require that a company disclose, for each loss contingency arising from pending or threatened legal claims, the plaintiff’s maximum loss claim, including any assertions that additional damages (such as treble or punitive damages) should be awarded or, if there is no quantified assertion made by the plaintiffs, the defendant company’s own estimate of its maximum possible loss. The Exposure Draft also would allow a defendant company to disclose its “best estimate of the possible loss or range of loss if it believes that the amount of the claim or assessment or the maximum exposure to loss is not representative of the entity’s actual exposure.” [Exposure Draft at Paragraph 7(a).]

While we believe that these three types of disclosure appear helpful in theory, we believe that as a practical matter, each of them is problematic and will lead to disclosure that is either meaningless or potentially both meaningless and extremely prejudicial.

1. *Plaintiff’s asserted loss.* We believe that history supports the view that, when asserting a claim, plaintiffs frequently, either as a matter of litigation strategy or simply as a publicity or investor relations matter, assert claims for damages that are far greater than those actually supported by the merits of the

statements promulgated under the Federal securities laws do not apply to statements included in a company’s financial statements.

case. Requiring a defendant to include such claims in its own public disclosure poses a real hazard of misleading investors and obscuring a fair understanding of what the real financial risk faced by the defendant is. Claims asserting hundreds of millions of dollars of alleged loss often are dismissed by courts or settled for nominal amounts. The path of least risk for an issuer—which will face the risk of liability for potentially misleading disclosure if it elects disclosure option (2) or (3)—will be merely to recite the plaintiff’s speculative damage claim. We respectfully submit that disclosure of these alleged damage amounts will not provide any meaningful information to a user of financial statements and will risk legitimizing the alleged damage amounts.

2. *Defendant’s estimate of maximum possible loss.* We also believe that requiring a defendant company to provide its own estimate of its maximum possible loss when the plaintiff has declined or failed to stipulate a maximum claim is also problematic. Our experience has shown that maximum theoretical losses rarely provide any meaningful insight into actual losses or settlement amounts associated with litigation and other commercial claims. Litigation outcomes frequently involve hundreds of individual decision points and other influences that unfold over extended periods of time. Accordingly, we believe that assuming the worst possible outcome of each individual influence to project a maximum possible loss amount will result in systematically inflated and unreliable estimates of actual potential loss. Requiring such disclosure is, in our view, as unrealistic as assuming that because individuals occasionally are run over when crossing the street, that each time a pedestrian leaves the curb he or she will not make it alive to the other side. Disclosure based on patently unrealistic probability expectations will be of no value to users of financial statements. And, as described below, acknowledging any risk of loss—let alone the theoretical maximum possible loss—invariably will prejudice the defendant. Among other concerns, we see a real danger that plaintiffs could use this disclosure to corner witnesses at trial, including the individuals at the company responsible for formulating the maximum damages estimate, and we worry that under such circumstances, defendants may lose their ability to assert privilege on these issues precisely because they previously provided public disclosure on point.

3. *Best estimate of possible loss.* We suspect that the FASB believes it has addressed the obvious deficiencies of quantification options (1) and (2) by permitting a company to also disclose its best estimate of the loss or possible range of loss. Unfortunately, despite the fact that disclosure types (1) and (2) will be suboptimal, due to the inherently prejudicial nature of disclosure type (3), we believe that companies will rarely—if ever—elect this approach. Doing so would create a significant risk that a potential claim would become a needlessly self-fulfilling prophecy.

FASB noted in paragraph 11 of the Exposure Draft the risk of prejudicial effect inherent in the proposed rules but then essentially disregards it by suggesting that it can be managed by aggregation of claims disclosure or, in rare circumstances, limited omission of sensitive details. We believe, however, that

the disclosure proposed by the FASB will create a substantial risk that financial statement disclosure will adversely and inappropriately influence settlement negotiations or the outcome of a trial. We fear that once a defendant company has valued a claim at a specific amount, that valuation will become a settlement “floor” and any intelligent plaintiff will refuse to resolve the claim for anything less—even if subsequent information makes it clear that the defendant had initially overestimated the strength of its opponent’s claim. And in cases where the defendant subsequently succeeds in resolving a claim for significantly less than its original estimate of its anticipated exposure, the initial disclosures could have been disadvantageous to investors who might have made investment decisions (such as deciding to sell the company’s stock) without fully appreciating the information’s unreliability. In circumstances such as those, the good-faith but incorrect disclosure might also harm companies and shareholders if the market subsequently devalues the company’s stock. In an extreme situation, this type of disclosure could even be viewed as an admission against interest effectively precluding the defendant from defending the substance of the claim against it. Thus, with this optional disclosure, plaintiffs would be given insight into the company’s assessment of its litigation position and its evaluation of the claims made by the other party. Disclosure of this proprietary and confidential information will be invaluable to plaintiffs and of limited utility to investors. Accordingly, even though a company’s best estimate of potential loss sounds to be valuable to a user of financial statements, we do not believe that companies will choose to supply this information.

Tabular disclosure.

Because we do not believe that mandatory quantitative disclosure of loss contingencies will be useful to users of financial statements, we do not believe that the proposed tabular reconciliation of loss contingencies will provide useful information for assessing potential future cash flows attributable to loss contingencies. In our view, the inherent uncertainties associated with the forced quantification of individual claims will only be compounded by requiring that estimates of each individual claim be aggregated and presented in a tabular format. In our view, individually meaningless numbers will become exponentially more meaningless when aggregated. For large companies with a significant inventory of loss contingencies, we believe that aggregating multiple “worst-case scenario” losses will quickly render disclosure of absolutely no predictive value to users of the company’s financial statements.

Qualitative disclosures.

The Exposure Draft also would require companies to provide a broad variety of new narrative or qualitative disclosures “including

- [a] description of the contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution;

- a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome;
- the entity’s qualitative assessment of the most likely outcome of the contingency; and
- significant assumptions made by the entity in estimating the amounts disclosed ... and in assessing the most likely outcome.”

In our view, any requirement to provide these disclosures would fail to provide meaningful benefits to investors and end-users in terms of understanding the financial condition of the public company defendant. Large companies may face hundreds of potential claims. Requiring companies to catalog, validate and disclose this data is a potentially enormous task. Given how quickly a significant development in a case may occur, even if these disclosures are only required on an annual basis, a company will nevertheless constantly need to assess whether its failure to update the disclosure may constitute a material misstatement or omission that would subject it to liability under the Federal securities laws. In addition this disclosure would subject an issuer’s chief executive and chief financial officer to potential civil and criminal liability under the Sarbanes-Oxley Act, and also as a result of Sarbanes-Oxley, be subject to an issuer’s outside auditor’s internal control over financial reporting audit. It is unclear to us how this data would be meaningful to investors, yet the potentially extraordinary costs of providing it seem obvious.

Risks posed to attorney-client privilege and work-product doctrine and the protections those provide for companies’ litigation strategies and documentation.

The proposed amendments would require the disclosure of numerous pieces of information that will necessarily be based on confidential information provided at least in part by a company’s internal or external counsel. We believe that disclosing this information will create a very real risk that a court may later determine those disclosures to have constituted a waiver of attorney-client privilege on the company’s part with potentially significant prejudicial impact to the company. In fact, we believe that any such deemed waiver could be held to apply to items far beyond the data actually included in the company’s financial statements. Similarly, if a company’s independent auditor requires access to counsel’s analyses and underlying data as part of its audit or review procedures, this too will increase the risk that the company will be deemed to have forfeited any attorney-related protections afforded that information and it may subsequently be made available to the company’s litigation opponents.

The proposed cure to the problem of prejudicial disclosures—aggregation at a higher level and possible omission in rare cases—does not mitigate the risk of investors being left with unreliable and potentially misleading disclosures.

The Exposure Draft seeks to mitigate some of the potentially negative impact of disclosures that would prejudice companies’ litigation positions by allowing for aggregation of claims at a level higher than the individual contingency or, in some

limited cases (under “rare” circumstances), omission of the prejudicial components of the required disclosures. In such cases, the reporting company would need to disclose the fact of the omission and the reasons behind it. While we appreciate the FASB’s recognition of the implicit prejudicial effects of the disclosure mandated by the Exposure Draft, we do not consider this “aggregation” alternative to cure the underlying problem. In many cases, a limited number of similar claims may constitute a disproportionate share of a company’s litigation exposure such that aggregation does not preclude disclosure of damaging claim-specific identifying information. And even where aggregation might be able to shield some claim-specific information, we do not believe that it render such information of no value to opposing counsel. As a practical matter, we also believe that many companies will legitimately believe that their circumstances are sufficiently rare that it is appropriate to omit the required disclosures. Because of the potentially prejudicial impact of complying with the proposed rules, we believe that compliance with the exception may be the most rational and appropriate approach for many companies.

IF ADOPTED, THE EXPOSURE DRAFT COULD PLACE SERIOUS STRAINS ON THE RELATIONSHIPS BETWEEN COMPANIES’ OUTSIDE COUNSEL AND THEIR INDEPENDENT AUDITORS

We believe that the Exposure Draft, if adopted as proposed, threatens to undermine the balance that has developed over the past several decades between the needs of a public company’s auditors for access to and the ability to test various sources for the disclosures contained in a company’s financial statements and the professional responsibility of a company’s counsel in safeguarding information covered by attorney-client privilege or the attorney work product doctrine.

The disclosures mandated by the Exposure Draft would place significant tensions on the rules of engagement that auditors and attorneys have reached regarding auditors’ inquiries of attorneys and attorneys’ responses to auditors’ requests for information (see Statement of Auditing Standards No. 12, *Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments* and the American Bar Association’s *Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information*.) We believe that this so-called “Treaty” has allowed auditors to satisfy their professional obligations without jeopardizing attorney-client privilege or confidential attorney work product. In our view, the Treaty would need potentially substantial reconsideration if the Exposure Draft were adopted as proposed, and we urge the FASB not to overlook the possible unintended consequence of impairing, even if for a limited time, the working relationships among companies, their independent auditors and their outside counsel in facilitating the preparation by companies of required financial disclosure.

THE PROPOSED TIMING OF THE RULE CHANGES SIGNIFICANTLY UNDERESTIMATES THE EFFORT REQUIRED TO COMPLY WITH THE PROPOSED CHANGES.

We believe that the proposed changes to SFAS 5 require significant additional analysis. Accordingly, we believe that it is not feasible for the FASB to

complete this analysis and promulgate a new rule that would be effective for fiscal years ending after December 15, 2008. As described above and, we suspect, in many other comment letters that the FASB will receive in respect of the Exposure Draft, we think there are many good reasons why the FASB should not proceed with a project of the magnitude of the proposals in the Exposure Draft on such a tight timetable.

CONCLUSION

In conclusion, we would like to note again our deep respect and appreciation for the difficult work that the FASB undertakes to improve financial reporting in the U.S. We support measured and well-considered disclosure of loss contingencies. Unfortunately, in our opinion adoption of the Exposure Draft would not enhance such disclosures and would be to the detriment rather than the benefit of investors. We would be happy to discuss the Exposure Draft and our comments with the Board or any members of its staff at your convenience, including by participating in one of the scheduled roundtable meetings.

CRAVATH, SWAINE & MOORE LLP

Very truly yours,

/s/ Robert H. Baron
Robert H. Baron

/s/ Andrew J. Pitts
Andrew J. Pitts

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Attention of Mr. Russell G. Golden, Technical Director

Via email to director@fasb.org

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