

August 8, 2008



LETTER OF COMMENT NO. 194

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: No. 1600-100

Re: Proposed Statement of Financial Accounting Standards: Disclosures of
Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)

Dear Technical Director:

We are outside counsel to many public companies. We have a substantial litigation practice dedicated to the defense of public companies in a wide-range of lawsuits. We also counsel our public company clients on a regular basis regarding their disclosure obligations under the federal securities laws and in that regard we are very familiar with FASB Statement No. 5 – *Accounting for Contingencies* (“SFAS 5”) and its requirements for disclosure of loss contingencies that are recognized as liabilities in a statement of financial position. We write to share our views on the proposal by the Financial Accounting Standards Board (“FASB” or the “Board”) to revise SFAS 5.

If adopted, the proposed revisions to SFAS 5 would change the reporting requirements with regard to the disclosure of loss contingencies, including those related to litigation, by requiring a reporting company to:

- (1) Disclose all loss contingencies unless the entity determines that the likelihood of a loss is remote.
- (2) Disclose any loss contingency, regardless of the likelihood of loss, if the contingency is expected to be resolved within a year and could have a “severe” impact on the company’s financial position.
- (3) Disclose the amount of a claim against it, or, if a claim amount is not provided, the reporting company’s best estimate of the maximum potential loss, with no exception for losses that cannot be estimated.

- (4) Provide detailed qualitative assessments of loss contingencies, including how the contingency arose, its legal or contractual basis, its current status, the anticipated timing of its resolution, a description of the factors likely to affect the outcome of the contingency, and the entity's assessment of the most likely outcome, including any assumptions made in estimating the amounts in the quantitative disclosures and in assessing the most likely outcome.
- (5) Provide a tabular reconciliation of recognized loss contingencies at the beginning and end of the period covered by the report, which includes at a minimum, increases for loss contingencies recognized during the period, increases resulting from changes in estimates of the amounts of loss contingencies previously recognized, decreases resulting from changes in estimates or derecognition of loss contingencies previously recognized and decreases resulting from cash payments (or other forms of settlement) for loss contingencies.

For certain loss contingencies such as pending or threatened litigation, where disclosure of certain information may be prejudicial to an entity's position, the entity may aggregate the disclosures at a level higher than the nature of the contingency such that disclosure of the information is not prejudicial. Only in "rare" instances where the aggregate disclosure would be prejudicial may the entity forego disclosing information that would be prejudicial.

We believe the proposed revisions will not achieve the Board's goal of providing better information to financial statement users because the unpredictable nature of litigation will result in speculative, unreliable and immaterial disclosures regarding those loss contingencies. Moreover, the proposed amendment to SFAS 5, if adopted, will disadvantage reporting companies in the conduct of litigation and undermine reporting companies' confidential relationships with their legal counsel.

The Increased Disclosure Requirements Will Inundate Users Of Financial Statements With Speculative, Misleading And Nonmaterial Disclosures

The amendments are proposed in response to "concerns expressed by investors and other users of financial information . . . that disclosures about loss contingencies under the existing guidance in [SFAS 5] do not provide adequate information to assist users of financial statements in assessing the likelihood, timing and amount of future cash flows associated with loss contingencies." Rather than achieving this goal, we believe the proposed amendments, if adopted, will result in unnecessarily excessive and immaterial disclosure. The proposed amendments require reporting companies to make disclosures about virtually all loss contingencies, including some "remote contingencies." This will lead to an increase in the number of loss contingencies that must be disclosed. Furthermore, the proposed amendment to SFAS 5 increases the number of quantitative and qualitative disclosures required. In many cases, these "enhanced" disclosures will not provide any material information to investors, but rather will result in the inclusion of non-material and speculative estimations of litigation-related loss contingencies. The United States Supreme Court's current definition of materiality, from *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), states that information is material if there is a "substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." A remote loss contingency and detailed information and analysis about it is not likely to be material to a reasonable shareholder.

Litigation is inherently speculative and quantitative disclosures in particular, especially in the early stages of litigation, are unreliable. There are dozens of judgments and weightings used in evaluating any litigation, including applicable law, the venue, the practices of the lawyers involved, the practices of the judge and/or magistrate involved, the current political and media environment and so on. Additionally, the motivation and financial consequences of a particular suit only come into focus over the lengthy litigation and discovery process and therefore the quantitative assessment of a loss contingency will very likely change over the course of a litigation. As a result, we believe the changes to SFAS 5 will likely not lead to enhanced disclosures of loss contingency, but to a deluge of insignificant, ever-changing and highly speculative disclosure concerning ongoing litigations which will only serve to make financial statements more difficult to assess.

A reporting company's estimate of its loss exposure in a particular litigation is also not likely to provide material information about the potential loss contingency because few litigations are tried to a final judgment. Indeed, according to the Bureau of Justice Statistics, more than 95% of all federal civil cases do not go to trial.¹ The majority of cases are settled rather than litigated to a judgment. Many actions settle without regard to the merits of the underlying case, but rather are settled in order to avoid the costs of litigation. Securities class actions in particular are prone to settlement because the one-sided nature of discovery in such cases means that they are much more expensive for defendants than plaintiffs. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 *Stan. L. Rev.* 497, 548-49 (1991). Such settlements are driven more by the potential costs (both monetary and non-monetary costs such as distraction of senior management or the intangible public relations effects of the litigation) or exogenous factors like the availability of insurance than by an estimate of either maximum or likely potential exposure. As such, disclosure of the speculative estimates of potential loss in the unlikely event of an adverse decision on the merits adds little or nothing to the total mix of material information, and disclosure of the other quantitative and qualitative factors (tangible and intangible costs, insurance, public relations considerations) would be speculative and could, as discussed below, prejudice the reporting company's ability to settle the litigations by revealing those factors to plaintiffs and their counsel.

Moreover, because many of the disclosures required by the proposed amendment to SFAS 5 will ultimately be proven to be inaccurate by subsequent events, they could have the unintended consequence of generating additional litigation. In this regard, disclosures that underestimate or overestimate potential loss exposures could have an immediate impact on the market price of the issuers securities. *Basic v. Levinson*, 485 U.S. 224, 241-42 (1988) ("The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business[.]") (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-1161 (CA3 1986)). When those estimates are subsequently "corrected", strike units may well follow with shareholder plaintiffs alleging that the issuer intentionally misrepresented its potential exposure. Such strike suits, in which a "plaintiff has simply seized upon disclosures made in later annual reports and alleged

¹ U.S. Department of Justice, Bureau of Justice Statistics Bulletin: "Civil Trial Cases and Verdicts in Large Counties, 2001," NCJ 202803, April 2004.

that they should have been made in earlier ones,” are routinely filed, despite being rejected as impermissible pleading of “fraud by hindsight.” *Denny v. Barber*, 576 F. 2d 465, 471 (2d Cir. 1978); see e.g., *Garber v. Legg Mason, Inc.*, 537 F. Supp. 2d 597, 615 (S.D.N.Y. 2008); *In re Pfizer, Inc. Sec. Litig.*, 538 F. Supp. 2d 621, 634 (S.D.N.Y. 2008). Even if these claims are ultimately found to be without merit, the issuer will nevertheless be required to expend resources defending them. As Justice Rehnquist has noted in describing the “in terrorem” effect of even meritless securities fraud claims, such claims present the “prospect of extensive deposition of the defendant’s officers and associates and the concomitant opportunity for extensive discovery of business documents.” *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741 (1975).

The Proposed Disclosure Requirements Will Undermine Reporting Companies’ Confidential Relationships With Their Legal Counsel

The proposed new disclosures are significantly more burdensome and detailed than those currently required. Reporting companies will necessarily rely on their legal counsel’s analysis and advice in estimating their maximum loss exposure and in describing factors likely to affect the outcome of litigation. Counsel’s analysis and advice, especially regarding pending litigation matters, is protected by the well-settled attorney client privilege and attorney work product doctrine, so that, among other reasons, open and forthright advice is provided by counsel. Requiring companies to disclose publicly details regarding their assessment of a pending or threatened case is likely to result in a waiver of the attorney client privilege and/or the attorney work product immunity because these protections do not attach to information intended to be made public. In these circumstances, we believe reporting companies may be reluctant to request robust analysis from their counsel, knowing such analysis would potentially not be protected. Moreover, requiring a reporting company to publicly disclose its estimate of litigation loss contingencies, could discourage attorneys from expressing views that a case does not have merit for fear of being second-guessed if their assessment is later proved to be incorrect.

The tension created by the proposed new rules between reporting companies and their legal counsel would be exacerbated by the effect the additional required disclosures would have on the audit process. Currently, the “Treaty”² between the American Bar Association (“ABA”) and the American Institute of Certified Public Accountants (“AICPA”) strikes a balance between auditors’ need to seek privileged information underlying public disclosures and attorneys’ need to limit their responses on the basis of privilege. The Treaty specifies that attorneys should “normally refrain from expressing judgments as to outcome except in those relatively few clear cases” where the outcome is either probable or remote. The ABA further cautions attorneys that “in most cases, the lawyer will not be able to provide any such estimate to the auditor.” However, predictions of outcomes are precisely the types of disclosures the proposed rules would require of a reporting company.

The more public statements a reporting company is required to make based on its legal counsel’s advice, the more privileged information auditors will have to seek in order to test those

² The “Treaty” consists of the ABA Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information, adopted by the ABA Board of Governors in 1975, and the AICPA Statement on Auditing Standards No. 12, adopted in 1976.

disclosures. Privileged information provided to auditors risks losing the protections of the attorney client privilege and work product immunity (*see, for example, Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y. 2002)).

The Proposed Disclosure Requirements Would Require Reporting Persons To Make Admissions Against Their Interests

Under the proposed rules, a reporting company would be required to quantify claims against it in one of three ways: reporting the plaintiff's claimed damages, reporting the entity's estimate of the maximum possible loss if the plaintiff does not claim a specific amount (which is more commonly the case), or, if the reporting company does not believe that those amounts reflect the real likelihood of loss, reporting the entity's estimated range of possible losses. Reporting the plaintiff's claimed damages is not controversial and is routinely done, as such information is generally publicly available and requires no analysis or interpretation by the reporting company. However, to require a reporting company to provide its own estimate of either its maximum possible loss or a range of losses and then disclose those amounts in a publicly filed document forces the company to signal to the plaintiff the company's assessment of its case, even where the plaintiff itself has been unable or unwilling to quantify the maximum amount of its own loss. Public statements such as these would be admissible as evidence against the company at trial as admissions against interest and the plaintiff could present a reporting company's estimate of its maximum loss exposure to a jury as an admission of liability. An estimated range of losses would also distort the normal course of settlement negotiations prior to trial by forcing a reporting company to reveal its best and worst case loss scenarios, which is information that is strictly guarded in order to obtain the best possible settlement for the company. The estimated range would impose a floor on possible settlement amounts before negotiations even begin, a floor that would likely be higher than any floor established through normal settlement negotiations.

The proposed rules would also require a reporting entity to disclose numerous details regarding a litigation, including the anticipated timing of its resolution, the factors likely to affect the outcome, and the company's assessment of the most likely outcome, including any assumptions made in estimating the amounts in the quantitative disclosures and in assessing the most likely outcome. This information will necessarily "show the company's hand" and reveal aspects of the company's defense and strategy, thinking that is carefully guarded in our adversarial litigation system. Additionally, this information would constitute a roadmap for plaintiffs to follow in seeking discovery. The "factors" a reporting company deems significant will reveal to plaintiffs what facts are likely to be important, what claims to focus on and what types of documents to seek. This, in turn, will encourage plaintiffs to file claims in the hopes that either a reporting company's disclosures would guide them to a basis for the claim after the fact or a reporting company would feel pressured to settle in order to avoid these extensive disclosures. Ultimately, a reporting company's publicly reported analysis could potentially be used against the company as admissions in the very litigation they describe, since many courts have found statements in publicly filed documents to be admissions against interest by defendants. The descriptions, therefore, would not only inform an adversary, but they could also be used by an adversary to influence a jury. Requiring the disclosure of such detail regarding ongoing litigation would therefore prejudice the company and its shareholders.

The Proposed Prejudicial Exemption Is Not Sufficient Protection Against These Harms

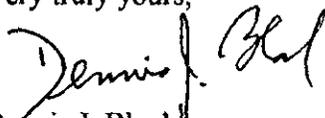
The proposed exemption from disclosing prejudicial information does not offer reporting companies sufficient protection from revealing information prejudicial to their litigation interests. If a reporting company determines that the required disclosures could affect, to the entity's detriment, the outcome of a contingency, the exemption merely allows an entity to aggregate its qualitative and quantitative disclosures for certain contingencies, such as pending or threatened litigation. However, for many entities, a single high profile case or type of case would constitute the bulk of the aggregate disclosure and so aggregation would not sufficiently disguise the prejudicial information.

Despite the inadequacy of the aggregation option, the proposed rules contemplate only "rare" cases when aggregation would be considered insufficient protection, such as the entity only having one legal dispute. In this instance, an entity may forgo disclosing the information deemed prejudicial. However, the proposed rules state that in no circumstance may a reporting company forgo disclosing the amount of the claim against the entity, including, if there is no claimed amount, an estimate of the entity's maximum loss exposure, as well as providing, among other things, a description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact on the outcome. Such an exemption, only available in "rare" instances, still requires the disclosure of potentially prejudicial information and will still potentially result in the waiver of attorney-client and work product privileges. As such, the proposed exemption is no protection at all.

We believe that SFAS 5 in its current form, as it relates to loss contingencies, does not need to be amended. The current version of SFAS 5 has been used effectively by reporting companies and users of financial statements for approximately thirty years. Reporting companies understand the requirements of the current SFAS and have developed procedures for handling and assessing loss contingencies. The current version of SFAS 5 provides users of financial statements with facts about loss contingencies that are "reasonably possible" of occurring and then allows users of financial statements to draw their own conclusions and assessments. The current SFAS 5 preserves the attorney-client and attorney work product privileges, maintains the adversarial nature of the United States legal system, is well understood and provides users of financial statements with all the relevant and material information. The unintended consequences of the proposed amendments would likely undermine these important principles.

We appreciate the Board's consideration of these matters and welcome the opportunity to discuss any and all related matters. Thank you for allowing us to comment on these issues.

Very truly yours,


Dennis J. Block