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LETTER OF COMMENT NO. 20

July 30, 2008

Via Email: director@fasb.org

Technical Director—File Reference No. 1600-100
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Amendments to FASB Statement No. 5

Director:

In connection with the proposed amendments to Financial Accounting Standards Board (“FASB”) Statement No. 5 and the draft memo (the “ABATF Memo”) prepared by the American Bar Association Task Force on Attorney-Client Privilege (the “Task Force”) as circulated on or about July 1, 2008, I would like to express my concern regarding the possible effects that the “Disclosure of Loss Contingencies” amendment would have on the current accepted standard of materiality. While the opinions expressed herein are mine, and not necessarily those of Keating Muething & Klekamp PLL, I believe I share the concerns identified by the Task Force in the ABATF Memo particularly relating to how the Exposure Draft threatens to change existing and well established definitions of materiality. The current definition of materiality adequately balances an investor’s interest in obtaining important information with a corporation’s interest in limiting disclosures. I feel that changes in this disclosure practice could lead to increased litigation regarding matters that are only marginally useful to investors. Ultimately, increasing the required level of disclosure as proposed is likely to hurt—rather than help—investors.

I. The Current Standard of Materiality

Each of Section 11 of the Securities Act of 1933, as amended, and Section 10(b) of the Securities Exchange Act of 1934, as amended, creates liability for omissions of “a material fact required to be stated . . . or necessary to make the statements therein not misleading. . . .”¹ The

¹ 15 U.S.C. § 77; 15 U.S.C. § 78.

classic definition of materiality is from the United States Supreme Court's decision in *TSC.v. Northway*.² The "total mix" test, as it has come to be called, provides:

[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote [p]ut another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.³

The FASB amendments to Statement No. 5 would require disclosure of all lawsuits that are expected to be resolved within the year. What the FASB is seeking squarely conflicts with the Supreme Court's precedent regarding disclosure. The FASB wants to require disclosure of information that clearly falls outside of the realm of "materiality." Requiring companies to provide non material information will march corporations and shareholders directly into the "parade of horrors" that the Supreme Court wisely anticipated.

II. The Adoption of the Materiality Standard

When the Supreme Court adopted the current materiality standard in *TSC*, it was exceptionally clear that it was concerned with the potential risks that over disclosure would create.⁴ The Supreme Court was concerned that a materiality standard that was too broad would: 1) create corporate liability for insignificant omissions or misstatements; and 2) induce corporations to "bury the shareholders in an avalanche of trivial information."⁵ This legitimate fear has been well accepted by lower courts. For example, in *In Re Sofamor Danek Group, Inc.*, the U.S. Court of Appeals for the Sixth Circuit refused to expand the scope of materiality, stating that a rule which required too much disclosure would "deluge investors with marginally useful information, and would damage corporations' legitimate needs to keep some information non-public."⁶

In addition to being adopted by the highest and most respected courts in the country, this standard has also been explicitly adopted by the U.S. Securities and Exchange Commission

² 426 U.S. 438 (1976).

³ *Id.*

⁴ *Id.* at 448.

⁵ *Id.* at 448-49

"Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. . . if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatement, but also management's fear . . . may cause it simply to bury the shareholders in an avalanche of trivial information – a result that is hardly conducive to informed decision making."

⁶ *In Re Sofamor Danek Group, Inc.*, 123 F.3d 394 (6th Cir. 1997). Further, corporations and corporate leaders are "not required to take a gloomy, fearful or defeatist view of the future; subject to what current data indicates, they can be expected to be confident about their stewardship and the prospects of the business that they manage." *Albert Fadem Trust v. American Electric Power Company*, 334 F.Supp.2d 985 (S.D. Ohio 2004) (quoting *Sinay v. Lamson & Sessions Co.*, 752 F.Supp. 828, 833 (N.D. Ohio 1990)).

("SEC"). In three separate rules or regulations, the SEC has adopted language similar to that of the Supreme Court.⁷ Further, the SEC considers the meaning of "material" so well established that three times in the past decade it has explicitly refused to define this term further or to increase its scope. First, in August of 1999, the SEC issued an accounting bulletin in which it concluded that purely quantitative steps should be rejected in favor of a test that looks to surrounding circumstances to determine materiality.⁸ Second, in adopting Regulation FD in 2000, the SEC refused to establish a bright line test, noting that the best way to resolve the difficulties of determining materiality was with flexibility.⁹ Finally, in promulgating rules for attorney conduct under the Sarbanes-Oxley Act of 2002, the SEC stated, "The final rule [SEC Rule 205] does not define the word 'material,' because that term has a well-established meaning under the federal securities laws and the Commission intends for that same meaning to apply here."¹⁰ Three times in the past decade the SEC has had the opportunity to increase the scope of materiality: all three times they have refused to change the standard.

Finally, beyond courts and the SEC, even Congress has acknowledged the risk that over disclosure creates. In passing the Private Securities Litigation Reform Act ("PSLRA"),¹¹ Congress acknowledged the burden that litigation regarding adequate disclosure had placed on corporations.¹² In a conference report, Congress stated that "Abusive litigation severely affects the willingness of corporate managers to disclose information to the marketplace."¹³ In addition, former SEC Chairman Richard Breeden testified before a subcommittee, "Shareholders are also damaged due to the chilling effect of the current system on the robust and candor of

⁷ 17 C.F.R. 230.405 (defining material as "... those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security."); 17 C.F.R. 210.1-02 (defining material as "... those matters about which an average prudent investor ought responsibly to be informed."); 17 C.F.R. 240.12b-2 (defining material as "... those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.").

⁸ 7 Fed. Sec. L. Rep. (CCH) ¶¶ 75,563, 75,701 (Aug. 12, 1999).

⁹ *Selective Disclosure and Insider Trading*, Release Nos. 33-7881, 34-43154, 2000 SEC Lexis 1672 (Aug. 15, 2000) "[W]hile we acknowledge in the "Proposing Release" that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of "material items" for purposes of Regulation FD. The problem addressed by this Regulation is the selective disclosure of corporate information of various types; the general materiality standard has always been understood to encompass the necessary flexibility to fit the circumstances of each case."

¹⁰ *Implementation of Standards of Professional Conduct for Attorneys*, Release Nos. 33-8185; 34-47276; IC-25919, File No. S7-45-02.

¹¹ 15 U.S.C. § 78u-5.

¹² H.R. Rep. No 104-369, Act § 102 (1995) ("Fear that inaccurate projections will trigger the filing of securities class action lawsuit[s] has muzzled corporate management. One study found that two-thirds of venture capital firms were reluctant to discuss their performance . . . because of the threat of litigation"); see *James Hamelton, Private Securities Litigation Reform Act of 1995: Law & Explanation* 16 (CCH Incorporated 1996).

¹³ *Id.*

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disclosure.”¹⁴ In passing the PSLRA Congress was seeking to bring abusive litigation back under control.

III. The Proposed Rule And The Potential Fallout

The FASB is overlooking the concerns of the Supreme Court, the SEC and Congress. Under the proposed amendments, corporations would be required to disclose significant amounts of information that may or may not be meaningful and certainly will be second-guessed. Too much information about potential outcomes of lawsuits will implicate the same concerns that the Supreme Court addressed over thirty years ago in *TSC*.

First, because the increased standard could create a fiduciary duty to disclose, companies would once again be subject to liability for failing to disclose trivial information. It is not difficult to imagine a situation in which corporations are sued because they misjudged the maximum amount of loss or the “remoteness” of a claim. Second, these proposed amendments go further than just creating the potential for burying shareholders in an “avalanche of trivial information,” – the proposed regulations affirmatively require the avalanche to occur. Providing information about all lawsuits will not make shareholders better informed. Instead, shareholders will be required to dig through the snow to determine which lawsuits are actually important to consider.

Third, as a result of the avalanche of information to be furnished, the shareholders’ bar and plaintiffs’ bar will acquire valuable new road maps to where corporations are being sued and insights into how seriously they may take possible exposures. Currently, many corporations try to lessen publicity to speculative areas of litigation as a result of being afraid of encouraging copycat suits. The additional information would similarly provide new grounds for suing companies over inadequately disclosed litigation risks. Fourth, defendants’ estimations of litigation risks, particularly if they are on the high side to stave off shareholder suits, will put downward pressure on the market price of a corporation’s stock and concomitantly increase its costs of raising capital. Consequently, corporations will have a new reason to cave and pay high settlements for the purpose of getting an even higher contingent liability off the books. Fifth, corporations concerned about liability for failing to disclose litigation risks will have an incentive to overstate such possible liability resulting from the ability of opposing counsel to use that data against them for the reasons stated above.

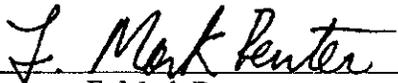
¹⁴ Private Securities Litigation Reform Act: Hearing on H.R. 1058 Before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, 104th Cong. (1995) (testimony of Hon. Richard C. Breeden, Former Chairman, SEC).

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Clearly, these concerns will give public corporations more reasons to go private and/or abandon U.S. markets. For the forgoing reasons and perhaps unintended consequences, I strongly urge against the adoption of the proposed FASB regulations. The risks that this added disclosure create far outweigh any benefits to investors.

Regards,

KEATING MUETHING & KLEKAMP PLL

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