COMMENTS OF THE NEW ENGLAND LEGAL FOUNDATION ON THE PROPOSED CHANGES TO FINANCIAL ACCOUNTING STANDARDS FOR DISCLOSURE OF CERTAIN LOSS CONTINGENCIES

(The Proposed Amendments to FASB Statements No. 5 and 141(R)

INTRODUCTION

The New England Legal Foundation ("NELF") submits the following comments on the June 5, 2008 Exposure Draft of a proposed Statement of Financial Accounting Standards entitled "Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)" ("Proposed Statement"). NELF is a nonprofit, public interest law firm, incorporated in Massachusetts in 1977 and headquartered in Boston. NELF's membership consists of corporations, law and accounting firms, individuals, and others who believe in NELF's mission of promoting balanced economic growth in New England, protecting the free enterprise system, and defending economic rights. NELF's more than 130 members and supporters include a cross-section of large and small businesses and other organizations from all parts of New England and the United States. Among its other activities NELF files amicus curiae briefs, publishes papers and articles, and convenes forums on legal issues of concern to New England businesses and property owners.

As is explained in greater detail below, NELF submits these comments because, in its view, the Proposed Statement would require businesses to make certain litigation-related disclosures that will alarm actual and potential investors and other users of financial statements without reasonable basis or legitimate purpose and will adversely affect the outcome of loss contingencies, to the detriment of all concerned. The provisions of the Proposed Statement that would require disclosure of the likely outcome of lawsuits, estimated maximum litigation loss exposures, limiting terms of insurance and indemnity agreements, and certain remote contingencies should not be adopted. They simply do not strike an appropriate balance between the need for disclosures regarding loss contingencies and the need to ensure that the reporting exercise does not itself cause financial loss.

I. The Proposed Disclosures Would Have No Reasonable Basis or Legitimate Purpose.

Paragraph 7b of the Proposed Statement requires a reporting entity to disclose its "qualitative assessment of the most likely outcome of the contingency"—in other words, whether it is likely to win or lose a piece of litigation or a group of cases of the same type that are aggregated for reporting purposes. Paragraph 7a of the Proposed Statement requires a defendant company, in the typical case where there is no specified ad damnum in a plaintiff's complaint, to disclose the defendant's "best estimate of the maximum exposure to loss" (or, as the Statement Summary phrases it, "the entity's best estimate of the maximum possible exposure to loss"). These proposed requirements assume,

incorrectly, that the likely outcome of litigation is reasonably predictable and quantifiable.

Litigation is by definition unpredictable. Many say that a party's chances in any lawsuit, no matter what its attorneys think of the claims and defenses on the merits, are no better than 50/50, simply because there are always at least two sides. Even highly experienced attorneys who specialize in litigation are frequently shocked by the results in cases. Juries nullify the law, and judges get it wrong. A great many legal questions have not been decided by appellate courts, and new facts can always come to light over the course of litigation that can dramatically alter the application of even established legal precedent. Defendants cannot count on opponents being amenable to a reasonable settlement, and arbitration is not always the answer either. In fact, many businesses complain that arbitral awards are typically unpredictable, "split-the-baby" compromises that bear no reasonable relationship to the value of either side's case.

To expect litigants to provide reliable predictions of the outcome of this inherently unpredictable process is to ask the impossible and provide the users of financial statements with meaningless or even misleading information. Given the general, "notice pleading" standard of most jurisdictions, it is also typically impossible to determine from the face of a complaint what relief the plaintiff truly seeks or expects. There is often a very broad range of potential relief and tremendous uncertainty about how a court will approach valuation of the claims and/or the facts that might come to light that will increase or decrease claim value. And the uncertainty is even greater in the case of a potential claim that has not yet been memorialized in any pleading.

Further, the maximum potential value of a claim will often be far greater than the plaintiff or its attorney has had any intention of seeking or hope of obtaining, and consequently the disclosure of the maximum potential value will unnecessarily raise concerns for those reading financial statements. It is, for instance, typical for a simple commercial claim with a potential maximum value in the hundreds of thousands of dollars to be settled for \$10,000 - \$25,000, or even less. Aggregating the estimated maximum values of such claims only aggregates unrealistically large numbers and misleads users of financial statements about the seriousness of loss contingencies.

Nor is there any purpose to disclosing the maximum potential amount of an unquantified claim. The highest potential value that could possibly matter to the user of a financial statement is the highest judgment or settlement outlay that can reasonably be expected.

A specific example may be helpful. Environmental statutes typically impose no-fault liability for environmental violations with enforcement alternatives ranging from informal administrative action (with no penalties), to formal administration action (with potential administrative penalties), to civil enforcement (with potential civil penalties), to criminal enforcement (with potential criminal fines and, for individuals associated with corporate defendants, even imprisonment). There is typically little, if any, formal guidance distinguishing what should be redressed administratively from what should be

prosecuted civilly or even criminally, with government personnel having tremendous discretion to choose among these enforcement options. Moreover, civil and criminal penalties are often available "per violation," with each day of violation of each subpart of regulations potentially counting as a separate violation. Before the government initiates enforcement action, it is generally impossible for a company to know which enforcement option will be chosen. And even when enforcement action is commenced, the government will not necessarily calculate the amount of administrative, civil, or criminal penalty sought or the number of violations to be counted (even from its perspective) for penalty purposes.

Thus, the Proposed Standard would have every entity that has learned of any alleged violation of any federal, state or local environmental regulations (which fill volumes), no matter how innocent or technical, disclose the possibility of criminal prosecution and imposition of the maximum potential fine for each day the alleged technical violation has continued (which could be years), even though the entity expects nothing more than a "slap on the wrist." Such a disclosure can only alarm without reasonable basis or legitimate purpose.

Companies have routinely indicated in their financial statements that they cannot estimate losses associated with complex claims and lawsuits because that is the reality. There are simply far too many factual and legal variables in complex business litigation to allow for reliable prediction of the likely overall outcome, let alone the particular relief to be afforded and its monetary value. The current disclosures declining to estimate losses are not evasive, but rather properly alert readers to the uncertain, unpredictable nature of these contingencies such that they can, if concerned, obtain additional information and form their own opinions about potential loss values.

II. The Proposed Disclosures Would Adversely Affect Contingency Outcomes.

A. Disclosure of Remote Loss Contingencies

It would be a logical contradiction to assert that reasonable people make important decisions based on avoiding risks that are not even "reasonably possible." Yet paragraph 6 of the Proposed Statement requires businesses to disclose such remote risks where the claims in question are expected to be resolved within a year and an adverse resolution "could have a severe impact on the entity's financial position, cash flows, or results of operations." This appears to require disclosure of claims that have only a slight chance (or even an extremely slight chance) of resulting in any loss at all, even when they are not expected to have a severe impact on the reporting entity if a loss does result. As long as there is any chance, however slim, of severe impact in the near term, disclosure is apparently required.

To require disclosure of such remote loss contingencies is to present them as information reasonably relied upon for decisionmaking, even though they are not, since otherwise there is no point to their disclosure. Actual and potential investors, creditors, and others reviewing a reporting entity's financial statement may therefore be misled into

acting on risks that are not "reasonably possible," to their own detriment and that of the reporting entity and all who have an interest in its financial viability. The greater the amount of the possible exposure, the more likely investors and others will engage in this irrational, albeit understandable, behavior even in the case of a loss that has virtually no possibility of occurring.

Consider a lawsuit that seeks a preliminary injunction against certain key business operation(s) or product line(s). Given the extraordinary nature of such pre-trial relief, and its fairly routine inclusion as a prayer for relief despite its general unavailability, the company may reasonably gauge the risk of loss as extremely remote, but the impact of such an injunction, were it to issue, might well be severe. Disclosure of the loss contingency, even while describing it as remote, would give it credence it does not deserve and might therefore cause losses to the company that would not otherwise be experienced.

The unfairness and undesirability of this result are compounded to the extent a remote loss contingency derives from an unasserted claim. While the Proposed Statement is unclear on this point, it arguably requires disclosure of even an unasserted claim that is not likely to be asserted and that would entail no more than a remote possibility of a loss if asserted, provided there could be a severe financial impact on the business in the near term were the claim in fact to be asserted and result in a loss. This treats the most remote of all possible loss contingencies—for example, an emotion-driven threat by a party not represented by counsel that does not even state a cognizable cause of action and should, if reason prevails, never result in an actual, let alone successful, claim—as information reasonably needed to guide the actions of others vis-à-vis the reporting company provided the potential claimant asserts an intention to seek relief that, if awarded, could have a severe impact on the company. The company will not necessarily be saved from disclosure by the proposed provision limiting disclosure to "near term" loss contingencies, since arbitration or other expedited resolution of the dispute might be required or likely. Nor, given the uncertainties of litigation and arbitration, could a company properly conclude that it would be impossible for such an unasserted, threatened claim to result in a loss.

Even if the intention of the Proposed Statement is to require disclosure of remote loss contingencies associated with unasserted claims that could have severe financial impact in the near term only when those unasserted claims are probable of assertion (an

¹ The lack of clarity regarding disclosure of remote, unasserted loss contingencies is even more fundamental. Unlike the language of the Proposed Standard itself, Section A.14 of Appendix A, "Background Information and Basis for Conclusions," suggests that the obligation to report certain remote loss contingencies under the Proposed Standard is not meant to apply to loss contingencies associated with unasserted claims at all. All of this would need to be clarified were the requirement of disclosing certain remote contingencies to be retained in the final Statement.

intention that would need to be reflected far more clearly in the language of any final Statement), that more limited requirement would still necessitate disclosure of an outlandish, threatened claim just because there is reason to believe the party involved will carry through on its threat. This gives unacceptable influence over the fate of reporting companies to desperate competitors, disgruntled employees, corporate gadflies, and others who are willing to pursue outrageous claims.

B. Disclosure of Likely Litigation Outcomes and Estimated Maximum Values

The disclosures required by paragraphs 7a and b of the Proposed Statement regarding the "most likely outcome of the contingency," the "significant assumptions made by the entity in estimating [the maximum loss exposure] and in assessing the most likely outcome," and the contingency's maximum possible value should not be adopted. By their very nature, such disclosures would often affect adversely the outcome of the contingency.

1. Disclosure of Predictions as to Likely Litigation Outcomes

If a company concluded that, despite potential defenses, there was more than a 50% chance it would be found liable in a single lawsuit or class of similar claims, the Proposed Statement would require the company to make a statement against its own interests informing opponents that even the company does not expect its defenses to carry the day, and why. Detailed work product of and privileged communications from defense counsel identifying and assessing potential legal and factual issues, protected at law from disclosure to opposing parties and their counsel, would now effectively be disclosed to the detriment of the defendant through the required recitation of the "significant assumptions" underlying the outcome prediction. This would completely subvert the adversary system, whereby parties and their counsel bear the burden of proving a case, and would likely increase substantially the amounts that companies must pay to resolve claims outside of court. Opposing counsel would likely find ways to ensure that judges become aware of these disclosures as well, potentially prejudicing judicial response to the defenses.

This required disclosure is inconsistent with and disrupts the privileged attorney-client relationship. It is lawyers (both outside and in-house counsel) who evaluate and advise businesspeople regarding the likely outcome of litigation. Neither attorneys' advice, nor the bases for their opinions, can be discovered in litigation because it is well recognized in the law that privileged communications between counsel and client, like protected attorney work product, serve legitimate interests that are fundamental to our system of jurisprudence. The Proposed Statement would effectively force disclosure of legal opinions and the bases for those opinions, chilling attorney-client communication and ultimately defeating the purpose of disclosure. In effect, clients would be encouraged not to seek their attorneys' honest opinions about their chances in litigation or any details regarding their attorneys' evaluation of subsidiary legal and factual issues. This could have serious negative consequences for decisionmaking in the litigation itself, and disclosures in financial statements would become uninformed, lay predictions by

parties with a stake in the outcome and every incentive to adopt an unrealistically rosy outlook on their prospects.

It is no answer to this dilemma that in "rare" cases the Proposed Statement would exempt the contingency from this disclosure requirement. It is the norm, not the exception, that a disclosure of this nature would be prejudicial. Moreover, an entity relying on the exemption would still have to explain "the fact that, and the reason why, the information has not been disclosed." As soon as a company indicated that it was claiming the exemption with respect to the likely outcome of a claim or lawsuit, it would be presumed that, in the company's assessment, the outcome will likely be adverse.

Assume for the moment that a company concludes it has valid defenses to a recent claim or lawsuit and intends to pursue those defenses vigorously to achieve a reasonable result, whether by settlement or full judicial process. Company lawyers have advised business leaders that the odds of prevailing are roughly 40%. Disclosing in a financial statement that the claim(s) will likely be lost will give "aid and comfort to the enemy" that cannot necessarily be alleviated by aggregation. There may be only one claim (or one claim of this type) against the company; or the issues (and, hence, the odds) may be the same with respect to the entire class of litigation to which a claim belongs (for example, in a product liability context because all the cases involve the same product with the same alleged defect and injury).

Under the Proposed Statement, the company in the above example must either disclose that it is likely to lose the case or group of cases or it must explain that it cannot reveal the likely outcome without prejudicing its interests. Either way, it is clear that the company has assessed the odds of prevailing at less than 50%. What began as lawyers' best advice to company officials based on their then (likely incomplete) understanding of relevant facts and their preliminary identification and evaluation of legal issues has now become a self-fulfilling prophecy, increasing the company's exposure. The company has lost (at least for settlement purposes and perhaps for purposes of judicial process as well) the benefits of any advantageous future developments in the case because its opponents' settlement expectations will have been raised (and judges' perceptions of the case potentially indelibly affected) by the initial disclosure, whether explicit or implicit, of a likely adverse outcome.

In fact, as was previously noted, if this aspect of the Proposed Statement is adopted, at least some companies will likely stop seeking professional assessment of their litigation odds. They will then have no proper basis on which to evaluate appropriate terms for settlement, making settlements far less likely. The resulting increase in litigation costs and burdens (including the opportunity costs of resource diversion) for both parties and the judicial system could be staggering. And, of course, compromise

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² It does not necessarily follow that an adverse judgment would be a just result. Litigation is an imperfect means to accomplishing justice, and an attorney's advice is based on the imperfect realities of our judicial system.

settlement payments would be replaced in many instances by higher judgments. All of this harms the reporting business and its shareholders.

2. Estimation of Maximum Possible Claim Values

Since most complaints do not specify the amount of damages or the value of other relief sought, paragraph 7a of the proposed Statement would place most defendants in the position of estimating their loss exposure. Requiring a defendant company to disclose its "best estimate of the maximum exposure to loss" (or, as the Statement Summary phrases it, "the entity's best estimate of the maximum possible exposure to loss") would have defendants signaling to plaintiffs claim values that may be far higher than what the plaintiffs had envisioned and would again effectively reveal defense attorneys' normally privileged work product whereby they evaluate and value claims.

The Proposed Statement indicates that the estimate of maximum claim value could be accompanied by a defendant's "best estimate of the possible loss or range of loss if it believes that the . . . maximum exposure to loss is not representative of the entity's actual exposure." It is unclear what is meant by either "possible loss" or "actual exposure," and clearer terminology would need to be employed in any final version of this provision. "Possible loss" and "actual exposure" both connote "maximum possible loss/exposure," in which case this option in fact adds nothing. Even assuming, however, that what is intended is to allow disclosure of the estimated range of possible loss where the maximum estimated exposure is greater than the likely or realistic estimated exposure, the required disclosure of the maximum estimated exposure still provides the plaintiffs with information that could impede efforts to settle the claim for a reasonable value and influence a court's approach to claim valuation to the company's detriment.

An example may again help illustrate the point. Assume that an abutting property owner has sued a business for alleged contamination of its property, seeking unquantified recovery for clean-up costs, diminution in property value, enhanced damages, and attorneys' fees. Most businesses are unlikely to have other, simultaneous claims of this nature to combine with this claim for reporting purposes, and yet the Proposed Statement indicates that defendant companies must nonetheless disclose their estimated maximum exposure to loss.

This kind of case involves a myriad of factual and legal issues, resolution of which will dramatically affect the plaintiff's likelihood of success and, if it succeeds, the value of its recovery. The source of the contamination is typically in dispute and may not be the responsibility of the defendant company at all. Discovery may reveal that the plaintiff was on notice of or even knew about the contamination for a long time and sat on its rights, such that recovery will be barred under applicable statutes of limitations, or there may be questions as to whether the plaintiff properly complied with statutory prerequisites to filing suit. The plaintiff may have itself undertaken some activity on its property that has contributed to the contamination, caused contamination to migrate to its property, or aggravated the costs of remediation or the impact on the value of its property. There may be unrelated, area-wide contamination that has commingled with

the contamination in question and/or affected neighborhood property values to the point where the contamination at issue arguably has no additional impact. The plaintiff may have performed an unnecessary, inefficient, or otherwise overly costly clean-up for which recovery (or full recovery) is unwarranted. The nature and extent of the contamination may be such that expert appraisers will reach widely divergent opinions regarding the fact and/or the amount of any diminution in the property value. It may be unclear what position, if any, government agencies with oversight authority will take with respect to the need for remediation or the proper remedial approach. Moreover, the law of the jurisdiction may be unsettled as to the proper approach to valuation of these claims. And there is tremendous uncertainty in the law generally regarding the calculation of punitive damages, with the consequence that a "run-away jury" may impose a punitive award that is grossly disproportionate to the amount of compensatory damages.

Despite these many open questions, the Proposed Statement would require a defendant company and its counsel to predict, upon the filing of a general and uninformative complaint (or even before), and without the benefit of factual discovery or other legal proceedings clarifying the plaintiff's expectations, the maximum amount to which the company may be exposed, which in this scenario could well be in the millions of dollars even without accounting for enhanced damages. When further proceedings reveal that there are very strong defenses to plaintiff's claims such that the likely recovery is minimal or nil, the defendant faces the virtually impossible task in subsequent settlement discussions of convincing the plaintiff to ignore the defendant's own, original indication of the maximum value of the claim. As a result the case will be far less likely to settle, to the disadvantage of both parties and the legal system.

C. Disclosure of Limiting Terms in Insurance and Indemnity Agreements

Similar considerations argue against the Proposed Statement's requirement in paragraph 7c that parties disclose detailed information about the terms of insurance and indemnity agreements. Those disclosures are to include applicable "limitations . . . that could affect the amount of the recovery."

Insurance and indemnity agreements are themselves often the subject of litigation because their proper interpretation and application is debatable. For instance, environmental insurance policies have been subject to litigation over what triggers coverage (i.e., is the "occurrence" that triggers coverage when the release of contamination first occurs, when it is discovered, or the entire time during which it is present in the environment), interpretation of the word "sudden" in provisions allowing coverage only for "sudden and accidental" pollutant releases, application of the "owned property" exclusion in the context of groundwater contamination, and the applicability of pollution exclusions to contamination that occurs as a result of another covered loss (e.g., fire or explosion). These and many other coverage issues remain highly debatable in many jurisdictions, and disclosing potential limitations on recovery would reveal legal reasoning regarding potential coverage problems that could aid the insurer in subsequent negotiations or litigation.

Decades of litigation over insurance and indemnity agreements in the environmental and toxic tort contexts demonstrate that it is far from the "rare" case where the terms of these agreements are debatable in their application such that the disclosures required by the Proposed Statement would prejudice pursuit of the insurance coverage or indemnity. Nor can aggregation necessarily alleviate the problem, since a single or limited number of insurers or indemnifying entities may be involved in all aggregated claims (e.g., a company's general liability insurer). Mandatory disclosure of potential limitations on recovery of insurance or indemnities is again simply too prejudicial to the reporting entity, and therefore ultimately harmful to investors.

CONCLUSION

For all of these reasons, the Board should not require businesses to predict the outcome of litigation against them, report remote contingencies, or disclose potential limitations in insurance and indemnity agreements. There is simply no way to impose such obligations without prejudicing the outcome of the reported contingencies. Similarly, any estimated claim value runs the risk of exceeding the value that a plaintiff and its attorney attach to a claim, with resulting prejudice to the reporting party. Therefore, quantitative disclosures should be limited to actual claim amounts specified by claimants.

The purpose of reporting loss contingencies is, of course, to inform users of financial statements of "the likelihood, timing, and amount of future cash flows associated with loss contingencies . . ." to the extent reasonably predictable. Proposed Statement, par. 4. The existing FAS5 Standard serves this purpose, while protecting the legitimate legal interests of reporting entities and thereby preserving shareholder value. The purpose of financial reporting is most definitely *not* to affect in any way the outcome of loss contingencies, and yet the aspects of the Proposed Statement discussed herein would do just that, to the detriment of both reporting entities and the very people the Board seeks to protect.

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