



LETTER OF COMMENT NO. 227

New York State Bar Association
One Elk Street
Albany, NY 12207
518-463-3200

Business Law Section
Committee on Securities Regulation

August 15, 2008

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

Email director@fasb.org

Re: File Reference No. 1600-100
Exposure Draft; Proposed Statement of Financial Accounting Standards
Disclosure of Certain Loss Contingencies

Ladies and Gentlemen:

The Securities Regulation Committee of the Business Law Section of the New York State Bar Association appreciates the invitation in the June 5, 2008 Exposure Draft of Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies (the "Exposure Draft") to comment on proposed disclosure requirements intended to amend FASB Statements No. 5, Accounting for Contingencies ("FAS 5"), and 141(R), Business Combinations.

The Securities Regulation Committee (the "Committee") is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was reviewed by certain members of the Committee, and the views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

SUMMARY CONCLUSION

In our view, the substantial changes proposed to be made regarding financial statement disclosures of certain loss contingencies pursuant to the Exposure Draft would risk significantly misleading users of financial statements. In addition, the disclosures that would be required pursuant to the proposed amendments, and the audit procedures

associated with those disclosures, could jeopardize the attorney-client privilege and be deemed to constitute admissions against interest. Further, the disclosure of highly sensitive, proprietary, competitive information could result in substantial harm to companies and their shareholders, and also could impose significant cost burdens on companies.

Were there a showing of compelling need for these changes, we could balance such need against the economic and competitive harm that could arise as a result of these changes, including the possible compromise of the attorney-client privilege. The Exposure Draft does not, however, make any showing of a compelling need for the proposed disclosures. That certain financial statement users may have indicated they would prefer a “highly uncertain estimate supplemented with a qualitative description [rather] than no quantification” provides scant comfort to a company and its representatives, auditors and attorneys, who would be required to prepare, certify, audit and opine on the highly uncertain estimates. The enhanced visibility of such highly uncertain estimates, and the potential for investors and others to rely on such information, increase substantially the risk that plaintiffs will claim that these required disclosures themselves provide a basis for claims against the companies and their representatives if contingencies ultimately turn out to differ from the estimates, as most surely they will do in many cases.

Accordingly, we respectfully urge the Board to withdraw the Exposure Draft. If the Board decides not to withdraw the Exposure Draft, we request the opportunity to meet with the Staff of FASB prior to adoption because of our concerns regarding attorney-client privilege and communications with clients. Also in such event, the changes proposed in the Exposure Draft should not be effective until fiscal years ending after December 15, 2009, at the very earliest.

The Committee, as an association of attorneys, is most concerned about the application of the Exposure Draft to pending and threatened litigation and unasserted claims. As a result, in addition to the concerns expressed in this letter relating to the implications of the proposed amendments in general, this letter focuses more specifically on the effect that the amendments would have on matters of concern to attorneys and, as a result, their clients.

DISCUSSION

Present FAS 5 Requirements

Under FAS 5, a loss contingency relating to a litigation or claim is generally recognized in the financial statements by a charge to income if an unfavorable outcome is “probable” (as defined in FAS 5) and the amount of the loss can be reasonably estimated. For loss

contingencies that do not meet both of those tests, FAS 5 currently requires certain disclosures if there is at least a “reasonable possibility” (defined as more than remote but less than likely that a loss or additional loss may have been incurred). In such a case, the entity is required to disclose the nature of the contingency and to “give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.” (Special rules apply for unasserted claims and assessments.) Generally, no disclosure is required where the possible loss is “remote”. Where accrual is required, FAS 5 also provides that disclosure of the nature of an accrual, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

The Exposure Draft Would Require An Entity To Quantify All Loss Contingencies Unless Liability Is Remote

The Exposure Draft would require an entity to quantify the possible loss in all cases where the loss is not remote, and would require an entity to state either the amount claimed or, where no amount is claimed, the entity’s own “best estimate of the maximum exposure to loss.” The entity would be permitted to give its own “best estimate of the possible loss or range of loss” if it believes the amount claimed or the maximum exposure to loss is “not representative” of the entity’s actual exposure. Even in those situations where the entity has recognized the contingency by accruing a charge against income, it would be required in all cases to disclose the amount it has charged. (Currently, disclosure of the amount accrued is required where necessary for the financial statements not to be misleading.)

In all cases where the contingency is required to be quantified, apparently including cases where the loss is probable and is accrued against income in the financial statements, the entity is required to provide descriptive information about the contingency, 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.” (Exposure Draft, Paragraph 7b.)

In addition, the entity also is required to provide information on relevant insurance or indemnification arrangements. Again, this insurance and indemnification information apparently is required to be provided with respect to probable losses accrued against income.

Even where the likelihood of loss is remote, all of the above quantitative and qualitative information is required for contingencies expected to be resolved within one year, where the contingency could have a severe impact on the entity.

Although the proposed standard may, at first blush, appear to enhance the transparency of entity disclosure, in fact the disclosures that would be required under the Exposure Draft would impose significant risks of materially misleading users of financial statements, and upsetting a critical balance by serving to assist those having interests inimical to the interests of the entity and its securityholders. To understand why it would have these results, we will examine each of these consequences:

- Risks of Materially Misleading Users of Financial Statements
 - Statement of Amount Claimed

Although requiring an entity to state the amount claimed by an adverse party in a litigation context has the initial appeal of setting a backdrop for further disclosure by an entity regarding its assessment of the claim, in many instances the amount claimed has absolutely no relationship to any bona fide expectation of the claimant as to the amount it is entitled to, or the amount it would be willing to receive in settlement of a claim. To the contrary, the amount is often chosen to shock the defendant, in a strategic effort to induce the defendant to take notice of the claim, to burden the defendant with the obligation or potential obligation of disclosing the claim to insurers and security holders, and generally to pressure the defendant to settle the claim on terms advantageous to the plaintiff.

The proposal in the Exposure Draft requiring an entity to state the amount of the claim in its financial statements would in all likelihood pass along the shock value to the recipients of the financial statements, regardless of the merits of the litigation. It may, in fact, encourage plaintiffs to increase the amounts claimed in litigations precisely to achieve this effect, in the hope or expectation that the entity's desire to avoid disclosure of the amount claimed, or the pressure that may be brought to bear on the entity to resolve a dispute facially involving large amounts of exposure, would add leverage to their bargaining position. Users of financial statements may not be in a position to know that there may be no difference between the merits of a claim for \$100,000 and one for \$100 million. Especially because the entity's characterization of "remote" is based on the merits of the claim rather than the amount claimed, users may in fact be led to believe that disclosure regarding a nominally large claim is included precisely because there is a "more than remote" possibility that the claim in that amount is meritorious.

Although an entity would have the opportunity (if it believes the amount claimed or the maximum exposure to loss is “not representative” of the entity’s actual exposure) to set forth its own “best estimate of the possible loss or range of loss”, there can be no assurance that a user of the financial statements will place any greater degree of reliance on the estimate than it would on the amount claimed. It may well be that an entity’s effort to candidly evaluate its possible loss will be viewed by a user of the financial statements as an effort by the entity to sweep a major exposure “under the rug”, perhaps more so if the amount claimed is extraordinarily large and the entity assessment significantly lower. We would view this battle of credibility as unhelpful to investors. To the extent that our capital markets have recently been affected in significant ways by the effects of rumors and irrational market sentiments, we view the Exposure Draft as risking adding an incendiary aspect to financial disclosures, the effect of which could be more to alarm than to inform.

- Best estimate of the maximum exposure to loss

Just as the disclosure of the maximum amount claimed in a litigation carries with it the significant risk that users of financial statements will be materially misinformed regarding a litigation matter, an entity’s best estimate of maximum exposure to loss could have a similar effect. The disclosure of such a maximum amount (which would presumably reflect every possible adverse assumption regarding the facts of a matter and the application of the law to those facts) would lie in the realm of fiction rather than fact. In many cases it may be even more pernicious than the disclosure of an asserted amount, because it would carry with it the entity’s own concurrence as to a possible result, regardless of how probable or improbable that result may be.

The efforts of regulators and standard setters in the securities and the accounting areas have, for some time, been oriented to the disclosure of material information. Concurrent with that is the realization that disclosure of immaterial information is not merely surplusage, but that such information may in many instances serve to obscure a user’s awareness of what information is, in fact, material. In our view, the disclosures proposed by the Exposure Draft would have that deleterious effect. Just as it would be inappropriate to require an entity, in its financial statements, to speculate as to the financial consequences to the entity if all its employees unilaterally terminated their employment, and all the entity’s contractual counterparties terminated or breached their contractual obligations, we believe that including highly uncertain information regarding the future outcome of litigation in a financial statement disserves, rather than serves, the interests of the users of those financial statements.

- Risks of Adversely Affecting the Entity's Interests

Not only is there the risk that the presentation of uncertain information in an entity's financial statements will serve to mislead users of the financial statements, there also is the risk that the information the Exposure Draft would require an entity to present would serve the particular interests of persons with interests hostile to that of the entity, specifically plaintiffs asserting claims against the entity and future potential plaintiffs. In the name of transparency, the Exposure Draft would require an entity to quantify its assessment of potential liability in connection with a matter. Although the information presented may be aggregated, this would not necessarily be the case. In any event it may be possible for counsel to a plaintiff to make a judgment, based on an entity's prior disclosures and changes to those disclosures, as to the entity's assessment of its liability in a particular case. Knowing the internal view of the entity would provide a plaintiff a significant tool which may well be used to the advantage of the plaintiff and to the prejudice of the entity. Because the plaintiff may not be subject to comparable disclosure, the one-sided disclosure of critical strategic information would place an entity in significant jeopardy that the costs associated with a litigation will increase substantially as a result of the required disclosure. From the vantage point of the lawyer to an entity, the risks are magnified, because the communications between the entity and its auditors would not be subject to privilege. If attorney communications to a client were communicated from the client entity to its auditors, the entity could effectively lose the protections of attorney-client privilege as to the matters disclosed. It seems wrong to risk subjecting an entity to significant harm in order to provide users of financial statements uncertain information.

The Tabular Reconciliation required by the Exposure Draft to reconcile the amounts of contingencies recognized at the beginning and at the end of each period (with its disclosure of increases for contingencies recognized during the period, increases from changes in estimates previously recognized, decreases in estimates, and decreases resulting from cash payments or other forms of settlement) will only exacerbate the harm to entities, as will disclosure of recoveries from insurance or indemnification arrangements.

In addition to providing unwarranted assistance to persons having interests adverse to an entity, the provisions of the Exposure Draft would open the door to an expanded realm of liability in situations where, regardless of an entity's good faith efforts to assess and disclose liability exposure, the ultimate outcome of the matter may differ materially from the entity's estimations. The amendments proposed in the Exposure Draft would provide readers an opportunity to compare the results of litigation with prior estimates, and to bring actions against an entity based on any material differences. As a result, the entity and those responsible for the management and affairs of the entity will be subject to

unprecedented risks of liability. In the case of public companies, these risks will not be subject to any limitation of liability for forward-looking information accompanied by meaningful cautionary statements. Under the Private Securities Litigation Reform Act of 1995, information set forth in financial statements is excluded from the scope of the safe harbor for forward-looking statements. It is our view that requiring public disclosure of inherently uncertain information, without the benefit of statutory safe harbors, will significantly increase liability exposure, and insurance costs, of entities and their directors and managements. In addition, the prospect of increased liability could serve to dissuade many qualified persons from serving on the boards of public companies, to the detriment of the companies and their shareholders.

The Exposure Draft denies the real possibility that an entity may not be able to estimate the possible loss or range of loss.

The Exposure Draft is premised on the flawed assumption that it is possible, in almost every situation, to estimate the possible loss or range of loss associated with a litigation. The disclosure proposed in the Exposure Draft does not take into account the process by which an entity develops an understanding of its exposure. At the inception of a litigation, an entity may have either no idea, or a significantly flawed understanding, of the potential scope of its liability. The entity may not have had the opportunity to engage in discovery or to have completed a sufficiently robust internal investigation to understand the factors that may give rise to its liability and its defenses to any such claims. Even during the course of that discovery and investigation, its views as to potential liability would likely evolve, based on its awareness of particular items of evidence that may be helpful or harmful to its position, the availability of witnesses, the nature of the discovery process relating to the basis for the claims being asserted and its defenses, and many other factors. Assessments of liability may also require consideration as to whether a matter is brought as an individual claim or a class action (and the potential for multiple claims), the jurisdiction in which the claim is brought, the procedural and substantive laws and rules that will be applicable to the litigation, the available precedents (which may change during the pendency of a matter), the legal, economic and reputational implications to the entity of settling or defending the matter, the reasonableness of the opposing entity and its counsel and many other factors too numerous to mention. In essence, the process of determining exposure is often a completely subjective exercise.

We are of the view that it is impossible to derive objective information from the aggregation of subjective judgments; instead, what results is only an aggregated subjective judgment. While accountants, attorneys, company management or others may speculate as to the likely outcome of a litigation, what results is no more objective than the totality of the information such persons have available to them in expressing their

views. In their comment letters regarding the Exposure Draft, accountants have expressed the view that they are not in a position to judge the estimate of a loss or range of loss associated with a litigation, and it has been suggested that lawyers may be in a better position to do so. We caution that although a lawyer may counsel a client as to his or her own view regarding a likelihood or quantification of loss, unless that view is based on an assessment of all relevant factors (and a knowledge of all relevant factors may not be achieved until rather late in the course of a litigation, if at all), there is no reason to believe that the good faith estimate of a lawyer prior to the completion of the litigation will necessarily be any closer to the eventual outcome of a matter than any other subjective judgment. In virtually all instances in our experience, the lawyer's guidance is sought not to attribute a specific value to a litigation for financial statement purposes, but to provide general strategic guidance to a client. The client can assess this guidance, in the context of all other information known to or obtainable by the client, to determine how best to approach and respond to the claim. While such attorney guidance may be helpful, management of an entity is generally aware that such guidance may be highly uncertain. Because, in our view, inherently uncertain information should not form a part of an entity's financial statements, auditors or users of financial statements should not be provided with such information.

Background of Attorney Confidentiality Obligations and the Attorney-Client Privilege in the Context of Audits of Financial Statements

One of the most carefully negotiated allocations of responsibility between the legal and accounting professions relates to the scope of an auditor's inquiry of a client's lawyer concerning litigation, claims and assessments, and the obligations of lawyers in connection with their responses to such inquiries. Because of the significant issues of confidentiality and attorney-client privilege implicated by such responses, the legal and accounting professions negotiated and approved, respectively, the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, 1975 (the "Statement of Policy") and the American Institute of Certified Public Accountants SAS 12, Statement on Auditing Standards, Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessment, January 1976 ("SAS 12", and collectively with the Statement of Policy, the "Treaty"). Although the Statement of Policy and SAS 12 by their terms refer to FAS 5, which at the time of their adoption was the accounting standard governing loss contingencies involving litigations, claims and assessments, we believe the issues addressed by the Statement of Policy and SAS 12 relate to all situations in which a lawyer's responsibilities to its client are implicated.

The Exposure Draft Could Impair The Treaty Between Auditors And Attorneys

The Exposure Draft could, if adopted, place significant additional burdens on attorneys in the context of auditor procedures associated with the audit of financial statements. Among other things, auditors may seek to discuss information and conclusions regarding pending and threatened litigations with both in-house and outside counsel. As Ernst & Young LLP notes in its July 31, 2008 comment letter to FASB on the Exposure Draft:

“As auditors, we need information from legal counsel to evaluate the appropriateness of the entity's accounting for and disclosure of litigation, claims, and assessments. The proposed Statement will result in a need for more information, including information about the prejudicial nature of the related disclosures. These assessments are not within the realm of an auditor's expertise.”

Ernst & Young added that: “The requirements of the proposed Statement will place significant tension on existing attorney-client privilege concerns.”

The Exposure Draft represents a sea-change in the qualitative and quantitative information regarding contingent liabilities required to be disclosed and thus available to adversaries and competitors, as well as accountants and auditors. The amendments proposed in the Exposure Draft threaten to undermine the Treaty's careful balancing of the interests of auditors and attorneys, which has served both professions and their clients well for these many years. Although attorneys and auditors may seek to define a common basis for operating under the proposed new standards, ultimately it is the reporting entities and their investors that will be most harmed if the Exposure Draft is adopted. Because the concepts underlying the Treaty are applicable in all instances where auditors seek to obtain, either directly or indirectly, information from attorneys regarding asserted or unasserted claims, the expansion of the disclosure obligations proposed in the Exposure Draft without a corresponding acknowledgement of the implications of the expansion to the attorney-client privilege represents, in our view, a fatal flaw in the proposal.

Disclosures Required By The Exposure Draft Could Jeopardize The Attorney-Client Privilege And The Attorney Work Product Privilege

Information relevant to the preparation of disclosure of estimates and the significant assumptions used for determining loss accruals may be obtained through a variety of means. If such information is obtained from lawyers, either in-house counsel or outside counsel, there exists a serious risk that such disclosure would represent a waiver of the attorney-client privilege, and the loss of the related client expectation of confidentiality of its communications with its attorneys. Society has determined that important public policy goals are achieved by encouraging clients to make full and candid disclosure of information to their attorneys, because such open communications makes it more likely

that an attorney will obtain the information needed to provide sound legal advice to his or her client. Obtaining sound legal advice is critically important to a society governed by law. Accordingly courts have recognized the value of the attorney-client privilege, and have sustained it even in circumstances where providing others access to this information would further other goals. Because of the significant public policy bases for maintaining the confidentiality of attorney-client privilege, the loss of the privilege could only have the effect of chilling such communications, to the ultimate detriment of the client and society.

As discussed above, the proposed disclosures would in effect require corporate clients to disclose otherwise privileged information, thus arguably waiving their right to assert the attorney-client privilege, and require their lawyers to waive the right to assert work product privilege. It is well-established that a corporation is entitled to the protection of the attorney-client privilege and the work-product doctrine.

An attorney who knows that the client may be compelled to disclose sensitive legal advice about a potential liability (including increases or decreases in the probable dollar amount of liability), or other sensitive information which can be gleaned from the disclosure of the estimates and assumptions, must advise the client that: (i) there is a requirement to disclose; and (ii) as a result, the attorney-client privilege may be waived and confidentiality of client confidences may not be preserved.

Finally, the policy behind the attorney-client privilege -- to facilitate the full development of facts essential to proper legal representation and to encourage clients to seek early assistance -- also serves to ensure accurate financial reporting. For example, FAS 5 specifically refers to the opinions or views of legal counsel among the factors to be considered in determining whether loss accruals are necessary.

The Proposed Exemption From Disclosing Prejudicial Information Is Inadequate

Under the Exposure Draft, the required disclosures are permitted to be aggregated by the nature of the loss contingency; for example, product liability or antitrust matters. In addition, where disclosure of information may be prejudicial to the entity's position, disclosures may be aggregated at a level higher than by the nature of the contingency. Finally, in "rare instances" when aggregating at a level higher than the nature of the contingency would be prejudicial, the entity may forgo disclosing only information that would be prejudicial, although it must disclose the fact that information has not been disclosed and the reason why.

Notwithstanding the above provisions for aggregating and, in "rare instances," forgoing disclosure, in all cases the entity still must disclose:

- the amount of the claim or assessment against the entity (or, if there is no claim amount, an estimate of the entity's maximum exposure to loss);
- a description of the loss contingency, including how it arose, and its legal or contractual basis;
- the current status of the loss contingency;
- the anticipated timing of resolution of the contingency; and
- a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential impact on the outcome.

The above disclosures, which would be required in all cases where there is prejudicial information, will cause the disclosure of sensitive, confidential or privileged information.

Finally, it is not apparent how the exemption from disclosing prejudicial information would apply to the Tabular Reconciliation, although the Exposure Draft states that the reconciliation is subject to the exemption.

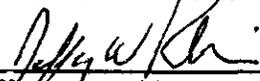
The Exposure Draft Is Not Workable

We refer to Appendix A, a summary of a federal securities class action litigation with a Chronology Comparing Events in the Litigation with the Defendant's Public Disclosures, include as part of the comments dated August 5, 2008, filed by the American Bar Association. That Chronology provides, in our view, irrefutable evidence that the Exposure Draft is not feasible.

We hope the Board finds these comment helpful. Should the Staff of the FASB so desire, we would be pleased to meet with the Staff to discuss these matters further.

Respectfully submitted,

SECURITIES REGULATION COMMITTEE

By: 

Jeffrey W. Rubin
Chair of the Committee

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Drafting Committee:

Howard B. Dicker
Richard E. Gutman
Michael J. Holliday
Richard R. Howe
Jeffrey W. Rubin

Copy to:

John White, Director, Division of Corporation Finance, Securities and Exchange
Commission

Conrad W. Hewitt, Chief Accountant, Office of the Chief Accountant, Securities and
Exchange Commission

Wayne E. Carnall, Associate Director and Chief Accountant, Division of Corporation
Finance, Securities and Exchange Commission