

LETTER OF COMMENT NO. 155







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August 8, 2008

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Mr. Russell G. Golden Technical Director 401 Merritt 7 P.O. Box. 5116 Norwalk, CT 06856-5116

Re: Proposed Revisions to FAS 5 - File Reference No. 1600-100

Dear Sirs,

We are the general counsels and senior litigation counsels for 12 large U.S. corporations. We appreciate the opportunity to comment on the June 5, 2008 Exposure Draft of a Proposed Statement of Financial Accounting Standards that would replace and expand FAS 5's disclosure requirements for loss contingencies that are (or would be) treated as liabilities, rather than asset impairments, in a statement of financial position. We believe that our experience as in-house lawyers who deal with litigation and litigation disclosures provides a unique perspective to comment on the potential operation and impact of the Exposure Draft. As a result, our comments focus on the specific application of the proposal to litigation-related loss contingencies.*

Our companies regularly face all manner of litigation claims, from the potentially meritorious to the patently baseless. We thus see firsthand the risks and costs to our stockholders arising out of this ever-increasing amount of litigation. We also are part of the internal teams that focus on providing litigation-related disclosures that are accurate and reliable. Based on our experience, we do not understand the need for the dramatic, far-reaching changes that FASB proposes. We believe, moreover, that the proposal suffers from three fundamental flaws:

First, the proposal would risk unfairly prejudicing disclosing companies in litigation, raising the overall exposure these companies face from litigation and ultimately harming the stockholders of these companies. Although FASB acknowledges this risk, our practical experience leads us to believe that FASB underestimates both its scope and its severity. The proposal's limited two-step exemption for prejudicial disclosures simply is incapable of preventing plaintiffs from gaining strategic insights and tactical opportunities from defendants' disclosures.

^{*} We wish to acknowledge the assistance of the Jones Day law firm in the preparation of this

Second, the litigation-related disclosures mandated by the proposal would not significantly benefit the users of financial statements. Here too, we believe that FASB underestimates the extent to which litigation, particularly in its early stages, is both highly unpredictable and dynamic. The types of disclosures FASB seeks to require do not, in large part, reflect information that is either readily available or easily measurable at most stages of litigation. Mandating disclosure in the face of such uncertainty will lead to disclosures that convey speculative information, meaningless generalities or misleading precision. Thus, the required disclosures will not improve the quality of material information available to the market but will impose potentially more risks upon reporting companies and ultimately their stockholders.

Third, the proposal cites no evidence that the existing disclosure system is inadequate. It provides neither empirical nor anecdotal evidence suggesting that the current disclosure regime, in conjunction with publicly available information about material litigation, fails to apprise the market of the risks underlying such litigation. And indeed, the available evidence suggests precisely the opposite. In preparing this submission, we commissioned several market event studies of litigation contingencies. Cornerstone Research, a leading expert consulting firm for complex litigation, assisted Professor Joseph A. Grundfest, a former SEC commissioner and current professor of law and business at Stanford University, and Laura E. Simmons, an assistant professor of accounting at the College of William & Mary, in conducting these studies. The results of these Cornerstone studies indicate that the public announcement of the settlement of litigation does not have a statistically significant effect on defendants' stock prices. This suggests that the existing disclosure requirements, combined with publicly available information, sufficiently informed the market about the litigation. In sum, FASB should not fundamentally change the existing disclosure rules in the absence of reliable evidence that the system is in need of repair.

For these reasons, we strongly believe that FASB should withdraw its proposed Exposure Draft, or at least extend the comment period, so as to enable further reflection and empirical analysis of the current disclosure system. If, after time for additional consideration and research, FASB concludes that financial statement users do in fact need more disclosure than is currently required, we recommend that future proposals take a more moderate, nuanced approach that would minimize the problems of prejudice and unreliability that plague the current proposal. ¹

I. The Proposal Would Risk Unfairly Prejudicing Disclosing Companies In Litigation

The United States employs an "adversarial system of justice" in which "truth – as well as fairness – is best discovered by powerful statements on both sides," such that "vigorous representation" and "forceful advocacy" are of "paramount importance." See Pension v. Ohio, 488 U.S. 75, 84, 85 (1988). FASB's proposal would seriously distort the legal system by creating a significant information asymmetry between the parties that will unbalance the "forceful advocacy" on which the system depends. Companies defending themselves in

¹ If any modifications to the existing rules are proposed in the future, we of course believe that the exact proposal should be circulated as an Exposure Draft with adequate time for comment. We also urge that any amendment to the rules should have a delayed effective date of at least a year after adoption, to give companies time to implement the necessary internal control and disclosure control procedures.

litigation who are subject to FASB's rules will be required to disclose sensitive assessments related to the litigation. Moreover, plaintiffs will often be unencumbered by these same obligations, either because they are not subject to FASB's rules or because, for them, the litigation will constitute a gain, rather than a loss, contingency. Thus, in most cases, only one side of a dispute will be required to make the sensitive disclosures proposed, while the other side will be able to gain unfair advantage from these disclosures. This heavy fist on the scales of justice in favor of plaintiffs is fundamentally inconsistent with the adversarial system. And the unwarranted harm that will result – the inevitable increase in the amounts of settlements and judgments for disclosing defendants – will fall squarely on defendants' stockholders.

FASB acknowledges this risk, but asks if the proposal's limited two-step exemption for prejudicial disclosures will solve the problem. It will not. To explain why, it is necessary first to detail the three principal ways in which the information asymmetry created by the proposal can potentially be used by plaintiffs to their strategic benefit, and then to analyze how the exemption is structured.

A. The Prejudicial Impact Of The Proposed Qualitative Disclosures

The qualitative disclosures required by the proposal will provide plaintiffs with an invaluable source of information to use against disclosing defendants, thus tilting the scale against these defendants. The proposed requirement to disclose the most likely outcome of cases will constrain the litigation positions that disclosing parties can take and undermine the company's defense. For example, plaintiffs likely will attempt to treat assessments of an unfavorable outcome as admissions that can be used in a variety of settings, such as to defeat a company's motion for summary judgment or in cross-examination of the company's executives. This requirement would have an even more unfortunate effect when companies face regulatory investigations, because the consequence of attempting to foreshadow the especially unpredictable outcome of such investigations brings its own risks from the regulator. Likewise, the requirement of disclosure about the expected timing of a matter's resolution also can be prejudicial: disclosing that settlement is imminent – because the negotiations are nearing an acceptable settlement range – will reveal defendants' hands to plaintiffs who will then be able to drive a harder bargain.

Moreover, the requirement to disclose significant assumptions underlying a defendant's assessment of the maximum exposure to loss and of the most likely outcome of a case, as well as the factors likely to affect that outcome, will give a plaintiff opportunities to reevaluate its case and change course if necessary. The assumptions and factors to be disclosed will provide a roadmap of the key issues in the case and the defense strategy. These qualitative disclosures may also reveal to existing and potential plaintiffs additional theories of liability and more expansive theories of damages – for example, defendants might disclose their possible exposure to statutory civil penalties of which the plaintiff was not even aware and would not have known to seek. And plaintiffs can use these insights: under most court rules, existing plaintiffs can add new claims and new theories of damages after the complaint is initially filed; new plaintiffs can include these theories in their initial complaints. Similarly, to the extent that the likely outcome and maximum exposure to loss is perceived to be affected significantly by defendants' ability to obtain a change in venue – due to perceived bias or unfavorable juries – courts and juries often will hold such disclosures against defendants when those disclosures are brought to their

attention. The tactics listed above are just a few of the numerous ways in which the mandated qualitative disclosures will hurt defendants in the underlying litigation.²

B. The Prejudicial Impact Of The Proposed Quantitative Disclosures

The quantitative disclosures required by the proposal are equally harmful. Requiring defendants to disclose their best estimates of the maximum loss exposure will put defendants at an immediate disadvantage at the outset of settlement negotiations because they already will have publicly disclosed their perceived maximum loss exposure. Judges may look unfavorably on arguments that damages are excessive as a matter of law when the amounts awarded are less than defendants' own assessment of the maximum possible exposure. A jury also might be inclined to exceed that amount "to teach the defendant a lesson" when the jury is considering punitive damages. Moreover, it is important to remember that the maximum loss exposure is often far greater than the likely loss, due to the wide range of possible outcomes in litigation. This fact will place defendants in a dilemma. Either they can permit this misleading number to go unrebutted in their financial statements, or they can counter this number with their internal assessments of their more likely loss exposure and thereby exacerbate all of the prejudicial effects listed above.

Although defendants would need to disclose their best estimates of maximum loss exposure only when plaintiffs do not demand a specified amount, FASB appears to overestimate the frequency with which a complaint will be available with such an amount. In cases involving large-scale, highly publicized disasters such as the Union Carbide gas leak in Bhopal, disclosure often will be required before formal legal proceedings will be initiated. Even when complaints are filed, the majority of states restrict the use of specific amounts in *ad damnum* clauses of complaints. In the remaining states and under federal notice pleading rules, plaintiffs are not required to specify the amount sought in their complaints, giving plaintiffs the option of omitting the amount to force defendants to disclose their perceived maximum loss exposure. Indeed, as discussed further below, in numerous types of cases, such as securities litigation, patent litigation,

² To give one final example, the requirement that information about insurance arrangements must be disclosed sometimes will enable plaintiffs to weaken a collective defense effort by driving a wedge between defendants and their insurers, and other times will give insurers ammunition in a subsequent coverage dispute.

³ For a good example of this point, consider the class actions filed in 2002 alleging antitrust violations against all underwriters of initial public offerings with respect to hundreds of IPOs conducted from 1997 to 2000, which sought treble damages of fees and other compensation associated with the underwritings. If defendants had been required to estimate and value those cases, the total damages would have run well into the billions of dollars and been "significant" to the major investment banks in the United States. But the underwriters ultimately prevailed before the Supreme Court and the actions ended in 2007 with no recovery by plaintiffs.

⁴ See, e.g., Ariz. R. Civ. P. 8(g); Cal. Civ. Proc. Code § 425.10; Colo. R. Civ. P. 8(a); Conn. Gen. Stat. § 52-91; Fla. Stat. §§ 768.042(1), 768.72; Idaho R. Civ. P. 9(g); Idaho Code Ann. §§ 5-535, 6-1604(2); 735 Ill. Comp. Stat. Ann. 5/2-604.1; Ind. R. Trial P. 8(A)(2); Iowa R. Civ. P. 1.403(1); Kan. Stat. Ann. §§ 60-208, 60-3703; Ky. R. Civ. P. 8.01(2); La. Code Civ. Proc. Ann. Art. 893 (A)(1)-(B); Me. Rev. Stat. Ann. tit. 14 § 52; Mich. Ct. R. 2.111(B)(2); Minn. Stat. §§ 544.36, 549.191; Mo. Rev. Stat. § 509.050; Mont. Code Ann. § 25-4-311; Nev. R. Civ. P. 8(a); N.J. Court R. 4:5-2; N.Y. C.P.L.R. § 3017(c); N.C. Gen. Stat. § 1A-1, Rule 8(a)(2); N.D. Cent. Code § 32-03.2-11; Ohio R. Civ. P. 8(a); Okla. Stat. tit. 12 §§ 2008(A)(2), 2009(G); ORS § 31.725(2); Pa. R. Civ. P. 1021(b); R.I. R. Civ. P. 8(a); S.C. R. Civ. P. 8(a); Tex. R. Civ. P. 47; Wis. Stat. § 802.02(1m).

and complex class actions, the complaint never specifies the amount sought. In such cases, years will often go by before plaintiffs actually are required to put forward their damage theories and the damages sought.

Moreover, even when an amount is specified in the complaint and is disclosed, that disclosure could be prejudicial. The reason why the majority of states have imposed restrictions on these amounts is because they frequently are inflated by plaintiffs to gain publicity, pressure defendants, and influence judges and juries. Thus, contrary to FASB's belief, these amounts are not "objective." If defendants nevertheless are forced to disclose these amounts, plaintiffs will have an incentive to use the threat of inflated ad damnum clauses as leverage to extract a settlement, capitalizing on defendants' reluctance to disclose the inflated number in their financial statements. Indeed, when the availability of this tactic is considered alongside the proposal's requirement that even remote contingencies must be disclosed so long as they are "near term" and of "serious impact," it appears likely that the proposal will encourage frivolous nuisance suits with exorbitant damages claims. Finally, as with the disclosure of maximum loss exposures, compelled disclosure of inflated ad damnum amounts will put defendants in the untenable position of either leaving these numbers unrefuted in their financial statements or harming themselves in the case by including assessments of likely loss exposure. Thus, for all of the foregoing reasons, the mandated quantitative disclosures pose a serious risk of prejudice.⁵

C. The Possible Impact On Attorney-Client Privilege And Attorney Work-Product Protection

The magnitude of the prejudice could worsen exponentially if courts find that the proposed disclosures vitiate the privilege for attorney-client communications and the established protection of attorney work-product. Attorneys for disclosing companies who prepare or review the proposed litigation-related disclosures may find it difficult to craft and assess these disclosures without drawing on and perhaps directly or indirectly revealing the underlying privileged and protected communications. Even if attorneys can draw these lines, plaintiffs and government regulators may argue that the disclosures constitute a broad waiver by defendants of privilege and protection, and thus may seek to discover and use against defendants their own attorneys' confidential analyses.

Moreover, auditors, who will be forced to substantiate the judgments underlying the disclosures, are likely to feel an increased obligation to request access to protected information in order to confirm the accuracy of the disclosures, given that the detailed quantitative and qualitative assessments mandated by the proposal may be based on numerous subjective factors conveyed between companies and their attorneys. Plaintiffs and government regulators may

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⁵ We thus agree with FASB's decision to omit from its proposal the suggested requirements that defendants disclose their best estimates of actual loss exposure as well as plaintiffs' settlement demands. It would only compound the problems with the proposal to require defendants to disclose these confidential and sensitive quantitative figures.

seek to leverage the auditing process by arguing that defendants who communicate with auditors about these disclosures waive their privileges and protections.⁶

D. The Proposed Exemption Will Not Actually Mitigate Prejudice

The various prejudicial effects of the proposal will not be solved by the limited two-step exemption for prejudicial disclosures. There are at least four serious flaws with the exemption.

1. Aggregation Is Unlikely To Be Feasible

Given the specific quantitative and qualitative disclosures that are required, aggregation of lawsuits of a different nature (let alone lawsuits with other types of loss contingencies) can be accomplished only at a very high level of generality. For example, when the outcome of one lawsuit depends on the determination of certain disputed facts, the outcome of a second depends on the resolution of key evidentiary disputes, and the outcome of a third depends on the answer to a dispositive question of substantive law, the three suits cannot be qualitatively aggregated other than to say that the outcomes depend on the resolution of questions of fact and law. Thus, aggregating to avoid case-specific prejudice will render the ultimate disclosures largely unhelpful to financial statement users. Furthermore, aggregation will not prevent arguments that attorney-client privilege and attorney work-product protection have been waived, especially to the extent that those arguments are premised on the role of outside auditors.

2. The Need For Omission Will Not Be "Rare"

Even if aggregation were generally feasible, FASB mistakenly believes that it will be "rare" for aggregation to fail to solve the prejudice problem. It is not uncommon for a single legal contingency to dwarf all other loss contingencies (litigation or otherwise), such that aggregation cannot shield case-specific, prejudicial information. Indeed, a "near term" loss contingency with a potentially "serious impact," by definition, is likely to be of such a magnitude that aggregation cannot prevent the harm that will result from the proposed qualitative and quantitative disclosures.

3. The Omissions Permitted Are Too Limited

Although the proposal would authorize omitting some disclosures (the qualitative assessment of the most likely outcome of the contingency and the significant assumptions made in assessing that outcome and in estimating the quantitative amounts disclosed), defendants must still disclose the mandated quantitative amount as well as the factors that are likely to affect the outcome and the anticipated timing of the contingency's resolution. Case-specific disclosure of this information will be prejudicial for the reasons previously discussed. And this disclosure

⁶ We agree with the comments of others who have stressed the impact of the proposal on the existing process for navigating these waters. For over three decades, attorneys and auditors have dealt with the tension between, on the one hand, disclosing litigation-related information in financial statements and, on the other hand, not waiving claims of privilege and protection according to the terms of the ABA-AICPA "Treaty." The proposal may well place substantial strain on the "Treaty" as auditors and attorneys attempt to perform their increasingly conflicting roles.

may still prompt plaintiffs' arguments regarding waiver of attorney-client privilege and attorney work product.

4. The Exemption Is Not Broad Enough

By its plain terms, the prejudicial exemption is limited to disclosures that will adversely affect "the outcome of the contingency itself." But disclosures will cause a variety of unwarranted harms to defendants that are unconnected to the specific contingency that is the subject of disclosure. Business competitors, for example, likely will use the disclosures to gain a competitive advantage. Or disclosed information about a case that is near final settlement might not prejudice the outcome in that case, but might still be useful to future plaintiffs in related (and even unrelated) litigation, thereby driving up the overall value of the company's future loss contingencies. And the prejudicial exemption arguably would not apply in these circumstances.

In sum, notwithstanding the two-step prejudicial exemption, the qualitative and quantitative disclosures mandated by the proposal will significantly compromise the availability of a full legal defense for disclosing companies and thus lead to less favorable litigation outcomes for their stockholders. And, for the reasons that follow, the proposal would impose these costs on disclosing companies without a corresponding benefit for financial statement users, because the mandatory disclosures about litigation will not be reliable.

II. The Proposal Would Not Significantly Benefit Financial Statement Users

FASB's proposal for broader, earlier, and more detailed disclosures about litigation contingencies is premised on the understandable desire to give financial statement users adequate information to assess the risk that litigation contingencies pose to companies. But "[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976). The Supreme Court's admonition is particularly apt here, because FASB's proposal would mandate that companies, from the very outset of litigation, disclose quantitative and qualitative information about unaccrued contingencies that is inherently unreliable given the unique nature of litigation contingencies.⁷

Litigation is a complex process that resolves disputes. By definition, the outcome is unknown and each party steadfastly expects a different outcome. The proposed disclosures risk substituting financial statement footnote disclosure for the judicial process. If valuation and investment decisions are made based on these disclosures, companies will be deprived of the safeguards of the judicial system. The outcome of a case is based on diverse factors including the application of constantly updating caselaw, the effect of larger trends in the law, the resolution of factual and evidentiary disputes, the judges involved, the venue, the litigation philosophies of the parties, the economies facing them, and the political and media environment.

⁷ Accrued contingencies, on the other hand, by definition have been reliably estimated and so the objections in this section do not apply to them. That said, precisely because defendants have deemed these estimates reliable enough to accrue, quantitative and qualitative disclosures concerning these estimates will be more prejudicial in the hands of plaintiffs, for all of the reasons discussed in the previous section.

Many of these factors will not be known or knowable at the time a complaint is filed (or for a long time thereafter). Moreover, the inherent unpredictability of litigation is exacerbated by its dynamic nature. Litigation is a process that plays out over time, and is not subject to the schedule of the quarterly disclosure calendar. Key legal rulings can occur at a moment's notice and fundamentally alter the likely outcome.

This unpredictability of litigation renders futile the proposal's attempt to require that companies provide detailed disclosures concerning unaccrued contingencies while the cases are still in their infancy. And this is true both for the qualitative and quantitative disclosures, as we briefly demonstrate below.

Qualitatively predicting the outcome of litigation is extremely unreliable, especially at the outset. For example, in smoking litigation, the tobacco industry has resolved thousands of cases with no liability whatsoever, but, when it has lost, the verdicts have ranged from hundreds of thousands to billions of dollars. Even after many years of data, there simply is no pattern. Likewise, in securities litigation, according to a recent study of cases filed in or after 1996, more than 40% of the cases that have been resolved have been dismissed without any payment, and so predictions made at the time of filing are unlikely to be accurate. Similarly, in patent litigation, until the claims are construed, it is not even clear what products are covered by the patent. And notably, the rate of reversal in patent claims construction ranges from 35% to 70% depending on the particular statistics used. Making predictions about the outcome of a contingency at the outset of litigation is particularly difficult in cases in which the information available to defendants at that stage is specifically and intentionally limited, such as in certain False Claims Act cases and governmental investigations. Finally, many materially significant cases are onetime events, rather than part of a series of related cases, and, in such circumstances, defendants are significantly constrained in the data that they can use to predict the outcome. Indeed, it is not uncommon for the evaluation of the potential outcome of massive litigation to change over time as the discovery process uncovers unforeseen documents and unanticipated witness testimony.

Quantitatively predicting the maximum loss exposure is equally unreliable at the outset of litigation. In many types of litigation, such as securities and patent cases, plaintiffs' theories of damages will be unknown until after their experts issue reports and provide deposition testimony – events that often do not occur until years after suits are filed and disclosures will have to have been made. Likewise, notwithstanding the Supreme Court's recent attempts to make punitive damage awards slightly less arbitrary, it is often difficult to predict which of a wide range of

⁸ Indeed, separate and apart from the difficulty of making predictions in some governmental and agency proceedings, defendants are often compelled to keep whatever information they have confidential. This is also true in certain types of commercial mandatory arbitration. FASB's proposal would put defendants in an untenable position when they are subject to confidentiality obligations.

⁹ The following five cases are particularly salient examples of this general rule: the elapsed time between the date the complaint was filed and the date the expert's damage report was submitted ranges from five to eight years. See Hillger v. Philip Servs. Corp., No. 1:98-cv-00835-AKH-DCF (S.D.N.Y.) (96 months); In re Xerox Sec. Litig., No. 3:99-CV-2374 (D. Conn.) (94 months); Gould v. Winstar, Inc., No. 1:01-cv-03014-GBD (S.D.N.Y.) (85 months); Aronson v. McKesson HBOC, Inc., No. 5:99-CV-20743-RMW (N.D. Cal.) (72 months); In re Tyco Int'l LTD Sec. Litig., No. 1:02-MD-1335-B (D.N.H.) (64 months).

punitive awards – from ten or more times the amount of compensatory damages down to nothing – will be imposed or upheld on appeal, because the jurisprudence at both the state and federal level is still somewhat unsettled. Moreover, penalties that can be imposed in governmental civil enforcement actions are wildly unpredictable, because a wide range is available and the specific amount is left to the discretion of the court or the bargaining of the parties. Indeed, the average range of such penalties has fluctuated significantly over the past 10 years. Finally, and to repeat, defendants have much less ability to predict the maximum loss exposure in one-time litigation than in a series of related cases.

Companies must of course assess litigation contingencies under the current FAS 5 to determine whether an accrual should be taken. But there is a critical difference between making the internal evaluation that a loss contingency is non-estimable for accrual purposes and making the extensive public disclosures about such contingencies proposed by FASB. Public disclosures of course will be relied upon by financial statement users and could give rise to collateral liability for errors: unlike the disclosures about litigation that SEC registrants currently must make in the Management's Discussion and Analysis ("MD&A"), the disclosures that FASB would mandate would not be protected by the safe harbor protection for forward-looking statements in the MD&A that Congress enacted in the Private Securities Litigation Reform Act of 1995. Disclosures that nevertheless attempt to obtain the unattainable precision that FASB desires will inevitably fall short, thus misleading financial statement users and generating collateral litigation over the errors. Alternatively, disclosures may avoid collateral liability by employing such breadth and generality, and so many stipulations and caveats, that their sole effect will be to drown financial statement users in a deluge of useless information. Either way, the mandated disclosures will not improve the quality of information available to the market.

III. The Proposal Provides No Evidence That The Current Disclosure Regime Is Inadequate

The current disclosure rules would have to be fundamentally flawed for FASB to consider amending them despite the serious problems of prejudice and reliability outlined above. The proposal, however, cites absolutely no evidence demonstrating such a dire situation. It offers no empirical evidence that there is a systematic defect with existing disclosures. Nor does it proffer empirical evidence that disclosures for certain types of contingencies are inadequate. Indeed, it does not even mention anecdotal evidence of insufficient disclosures. In sum, FASB proposes a fundamental and deleterious change to the current disclosure requirements, but has given no justification for why such a change is necessary.

Moreover, based on the available empirical evidence, there is good reason to believe that the current system functions well. At our request, Cornerstone conducted several market event studies that were designed to determine whether the public announcement of the final resolution of litigation has a statistically significant effect on defendants' stock prices. The absence of such an effect would indicate that the ultimate cost of the contingency is already incorporated into the stock price of the company. This in turn would suggest that the current disclosure regime, in conjunction with publicly available information about material litigation, adequately apprises the market of the risks underlying such litigation. In other words, if the market is not affected by the public announcement of the ultimate resolution of litigation contingencies, then that indicates that expanded disclosures about such contingencies are unnecessary because the current

disclosures are sufficient to inform investors. 10 Although these studies will be submitted as a separate comment by their authors, we summarize the results herein.

In the limited time available, three sets of data were analyzed: (1) settlements of securities class-actions with final court approval in the 18-month period between January 2007 and June 2008; (2) the 50 largest total settlements of securities class-actions between 1996 and June 2008; and (3) the resolutions of all non-securities-litigation cases involving public-company defendants that were reported in the Wall Street Journal between January 2006 and June 2008. In all three data sets, the public announcement of the settlement of the cases did not have a statistically significant effect on stock prices.¹¹ To repeat, the fact that stock prices were not affected by the announcements of the settlements suggests that the available mix of information was adequate for the cases to be evaluated without the need for any additional disclosures. And it is important to recognize that the lack of a statistically significant effect holds true even when each of the individual companies is considered separately. For example, in the first data set, of the companies whose settlements were publicly announced in the absence of potentially confounding information, more than ninety percent of those companies' individual stock prices were statistically unaffected by the announcement. This is important because it forecloses the possible objection that, while there was insufficient information about litigation for individual companies, those omissions caused equivalent amounts of over- and under-valuation that canceled each other out. Instead, the evidence suggests that, even at the level of individual litigation contingencies, the market was adequately informed about such contingencies prior to the public announcement of their settlement.

As Cornerstone discusses, the results of these studies are consistent with the prior literature on this topic. The consistency of result in such studies should not be surprising, because there are good reasons to believe that additional disclosures mandated by FASB are unnecessary. In addition to the existing FAS 5 disclosure requirements, registrants are already required by the SEC to disclose in the MD&A trends, events, and uncertainties that are likely to materially affect future operations, liquidity, or the company's survival. Furthermore, the market gets additional information as a consequence of the fact that, in general, court

¹⁰ It is important to note that the inverse is not necessarily true: the existence of a statistically significant market effect does not prove that the disclosures were inadequate. For example, in cases with intrinsic uncertainty – cases where there is some probability that the jury will rule in a company's favor, and some probability that it will rule against – even if defendants perfectly predicted and disclosed the relevant probabilities, the stock price would still be affected when the jury ultimately resolved the uncertainty. In short, with respect to the adequacy of litigation disclosures, the absence of a statistically significant market effect is more probative than the presence of such an effect.

¹¹ In the third data set, the public announcement of the non-settlement resolution of cases against public-company defendants did have a statistically significant effect on stock prices. But this does not prove that disclosures about such cases were inadequate, given that, as discussed above, the resolution of certain types of litigation contingencies will have stock price effects even when prior disclosures are perfect.

¹² For example, an examination of disclosures by companies that have experienced mass tort litigation will show that registrants in complying with these rules do disclose significant additional information concerning litigation as to both historic trends and outlooks for the future. And an examination of SEC comment letters will show that the SEC has been active in overseeing disclosures about such information.

proceedings are public. As other comments have highlighted, financial analysts and sophisticated market participants follow material litigation. There is no reason to believe that all of this information is insufficient to permit the market to incorporate the risks of litigation into a company's stock price.¹³

Given the brief comment period, there was only a limited time to design and implement these studies. Nevertheless, these initial results, combined with the absence of any documented evidence to the contrary, should give FASB pause. We suggest that FASB should withdraw its proposed Exposure Draft and, if it still suspects that there is something wrong with the current disclosure regime, commission further research to identify precisely what, if anything, the problem is. If that research reveals a disclosure system deficiency, FASB at that point should consider a more moderated, nuanced approach that would be targeted at the documented flaw, but that would minimize problems of prejudice and unreliability. This could be accomplished by allowing a company to adjust disclosures to its particular situation, such as by giving it some freedom to determine whether particular information is too prejudicial to be disclosed, can be disclosed in a less prejudicial fashion, or is too unreliable to be included.

Conclusion

Litigation is the process for establishing and valuing the rights of parties in disputes. The Exposure Draft, as presently structured, risks substituting footnote disclosures for the judicial process in assessing what defendants will pay for claims, while tilting the scale to plaintiffs in the litigation arena. Defendants will be required to disclose information about past events and make predictions about future events, even though those disclosures are likely to be unreliable and to disadvantage them in pending and future litigation. This will be compounded by second-guessing when actual results vary from the range of disclosed outcomes, and will generate further litigation. The creation of the prospect of this substantial prejudice is not warranted given the absence of evidence indicating that the current disclosure system is inadequate.

The fact the market reliably predicts the ultimate outcome of individual litigation contingencies in no way detracts from our previous argument that the disclosures FASB proposes are unreliable. First, and most importantly, FASB would require disclosure at the outset of litigation whereas our empirical evidence shows that the market is not surprised by the outcome of litigation once it finally arrives. Second, the market is an aggregation of a multitude of individual predictions about the outcome of a litigation contingency. Any individual prediction might well be wrong, even though the aggregation is right. But companies, unlike voluntary market participants, potentially face collateral liability for making erroneous predictions about litigation outcomes.

Respectfully submitted:

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