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BY E-MAIL AND OVERNIGHT MAIL

LETTER OF COMMENT NO. 67

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
File Reference No. 1600-100
Email: director@fasb.org

Re: Exposure Draft, Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, an Amendment of FASB Statements No. 5 and 141(R)

Dear Mr. Herz:

We write to comment on the Exposure Draft issued June 5, 2008 concerning Disclosure of Certain Loss Contingencies. While we support the Board's goal of providing "adequate information to assist investors in assessing the likelihood, timing, and amount" of potential losses from litigation contingencies, we do not believe the proposed Statement would achieve this goal in practice, and it would seriously compromise the ability of public companies to defend themselves in the disclosed matters. To highlight the operational difficulties and adverse consequences of the proposal in the context of actual litigation, we have sought to illustrate our concerns where possible with concrete examples drawn from our experience or that of other companies.

Our Perspective. The Hartford Financial Services Group, Inc. (The Hartford) (NYSE:HIG) is a diversified insurance and financial services holding company offering investment products and individual life, group life, group disability, and property and casualty insurance products through its operating subsidiaries. In 2007, our revenues were $25.9 billion and our net income was $2.9 billion. Both The Hartford and its indirect, wholly-owned subsidiary, Hartford Life Insurance Company, are SEC registrants.

Hartford Investment Management Company (HIMCO), a wholly-owned subsidiary of The Hartford, is an investment management company and registered investment advisor with $148.7 billion in assets under management as of year end 2007, of which $92.5 billion are managed for The Hartford's own accounts and $56.2 billion for third parties. HIMCO actively manages an extensive portfolio of public as well as private equity and debt.

The insurance business, by its nature, is litigation-intensive. At any given time, The Hartford and its affiliates are parties to thousands of pending lawsuits, including class actions, bad faith actions, and others that may meet the criteria for disclosure under SFAS 5. The Hartford Law Department currently employs almost 60 in-house counsel devoted full-time to the management of litigation against the company and litigation-related counseling.

We therefore have considered the proposed Statement from several different institutional perspectives: as an issuer of financial statements, as a user of financial statements, and as a frequent defendant in high-exposure litigation.

Summary of Position. We support the Board's goal of more transparent, comparable, and complete disclosure concerning loss contingencies. As the Board recognizes, however, litigation poses special challenges for disclosure because of the risk that the disclosure itself will adversely affect the outcome of the contingency. For loss contingencies arising from pending or threatened litigation, we believe that the current SFAS 5 regime strikes an appropriate balance between transparency for investors and preservation of the reporting entity's ability to defend the suit. Many of the additional qualitative disclosures required under the proposed Statement—specifically, the *factual* disclosures as opposed to those relating to predictions and assumptions—are consistent with this balanced approach and may provide incremental benefit to investors.

The quantitative disclosures mandated under the proposed Statement, however, are highly problematic. They appear to rest on two mistaken factual assumptions about the position of a defendant in large, complex cases in the American legal system.

First, the proposed Statement assumes that it is always possible to make a reasonable estimate of an entity's "maximum exposure to loss" in material litigation, regardless of the nature of the case or the stage of the litigation. This is not true. The cases that may trigger a disclosure obligation for large public companies typically are not susceptible to any meaningful valuation for a substantial portion of their multi-year life cycle. Moreover, any effort to quantify the magnitude of the exposure would be based largely or entirely on the subjective judgments of counsel, which our legal system ordinarily protects from disclosure.

Second, the proposed Statement assumes that the required disclosures will be prejudicial to the reporting entity only in "rare instances." To the contrary, disclosure of a defendant's internal best estimate of its maximum exposure to loss to its litigation adversary would prejudice that defendant in virtually *all* instances. The solution

suggested in the proposed Statement—aggregation "at a level higher than by the nature of the contingency"—will seldom cure the problem, because few companies have enough material litigation for aggregation to shield the prejudicial information effectively.

These two mistaken assumptions have resulted in a proposal that is deeply problematic for issuers while yielding no substantial benefit for users of financial statements. As an issuer of financial statements and a frequent defendant in high-exposure litigation, we believe that the estimates of loss required under the proposed Statement would be impossible to develop in a responsible way. The proposed Statement would thus compel an issuer to disclose to the investing public, in the guise of fact or informed judgment, speculation about future events that the issuer itself believes has no factual basis and therefore no meaning. In addition, such disclosure would seriously compromise the issuer's interests in defending the very suit that is the subject of the disclosure, including through compelled disclosure of otherwise privileged attorney-client communications and attorney work product. And as a user of financial statements, we do not believe that the additional quantitative information would achieve the Board's goal of enhanced disclosure. Such information would not be useful for us or other investors because it would lack the certainty or predictive value necessary for a user to make an investment decision.

Below we elaborate these points through the use of examples based on recent real-world situations involving The Hartford or other public companies.

Point 1: A meaningful estimate of the "maximum exposure to loss" is often impossible to make at the time disclosure is first warranted and for years thereafter.

> *Example 1*: A State's Attorney General is investigating a widespread practice in an industry that is heavily regulated under state law. No law or regulation makes this practice illegal. The Attorney General issues subpoenas to more than a dozen companies and receives information in response. On Day 1, he holds a press conference announcing that he has commenced an action against Company A, a public company, alleging abuses in relation to the practice under investigation. The complaint (which is publicly filed) alleges that Company A's abuses have involved Companies B, C, and D, also public companies, but the complaint does not join those companies as defendants. The complaint does not quantify the Attorney General's claims.
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> On Day 1, beginning immediately after the press conference, the stock price for all four companies drops, and it continues to drop for several days thereafter.
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> By Day 10, each of Companies A, B, C, and D has been served with "copycat" complaints by private plaintiffs based on the Attorney General's allegations against Company A. These include class actions alleging antitrust, racketeering, and state-law violations; class actions alleging securities fraud; class actions alleging ERISA violations; and derivative actions. None of these complaints quantifies the claims.

Companies A, B, C, and D each are due to file their Forms 10-Q with the SEC within two weeks of the Attorney General's press conference.

Analysis: Under the current SFAS 5, each of these companies would be prudent to disclose the filing of the actions against them, as well as, in the case of Companies B, C, and D, the Attorney General's mention of them in his case against Company A—even if they do not view any of the allegations as meritorious. These are public companies in a regulated industry, and it is unlikely to be feasible for them to engage in a protracted, high-stakes litigation battle with an important regulator. The market reaction to the press conference confirms that this is the market perception as well.

But under the proposed Statement, how would they disclose a "best estimate of the maximum exposure to loss"? Neither the Attorney General nor the private plaintiffs have made a demand. There has been no discovery and no motion practice. The defendants know little more about the claims against them than what is in the complaints—publicly filed documents that are available to any analyst or investor. They have no idea who the Attorney General thinks was damaged by their alleged conduct, in what way, and in what amount. Indeed, as to Companies B, C, and D, the Attorney General has not even filed claims yet (and may never). Whether and in what circumstances a court would find the widespread industry practice to be unlawful or even within the Attorney General's jurisdiction to challenge is unclear. With regard to the private actions, the companies do not know if a class will be certified, who will be in the class, and what damages (if any) the class might be able to prove. Many other pre-trial events that will have a substantial impact on the risk of loss from these cases have yet to unfold—motions to dismiss, motions for summary judgment, discovery, expert reports, and evidentiary rulings, to name a few—even before the companies face the inherent unpredictability of a jury trial. The plaintiffs' appetite for and expectations regarding settlement are unknown—indeed, cannot be known, because the plaintiffs are not yet in a position to value their claims either. In short, for all of these companies, all that can be said about the outcome of these related cases at this juncture is that a loss is reasonably possible and it could be material. There is no rational basis on which to estimate the extent of the potential loss; there are simply too many unknowns and variables.

Viewing this example with hindsight as well as foresight may help to illustrate further how subsequent events—unknown to the reporting entity at the time disclosure is first warranted—can yield wide variations in outcome that are difficult to predict and impossible to quantify at earlier stages of the case.

> *Example 1 in Hindsight.* The actual situation on which the example is based began about four years ago. Since then, the situations of Companies A, B, C, and D have diverged widely in relation to the Attorney General's investigation and ensuing private litigation.
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> Company A resolved its dispute with the Attorney General for hundreds of millions of dollars. It settled its dispute with the antitrust/racketeering plaintiffs

for the undistributed proceeds from its Attorney General settlement, plus attorneys' fees. Its securities, ERISA, and derivative actions are in active litigation. Several of its employees pled guilty to crimes related to particular instances of abuse in connection with the widespread industry practice under investigation.

Company B resolved its disputes with the Attorney General for more than a billion dollars, but the settlement also embraced some serious, unrelated issues uncovered in a separate investigation. The trial court dismissed the consolidated antitrust/racketeering suits against it, and an appeal is pending. Its securities and derivative actions are in active litigation. It has reached an agreement in principle to settle its ERISA actions. Several of its employees also pled guilty to related crimes.

Company C resolved its dispute with the Attorney General for about 10% of Company A's settlement. The trial court dismissed the consolidated antitrust/racketeering suits against it, and an appeal is pending. A motion to dismiss its securities action was filed years ago and has yet to be decided. Derivative actions are pending. Several Company C employees also pled guilty to crimes.

Company D resolved its dispute with the Attorney General for an immaterial amount. The trial court dismissed the consolidated antitrust/racketeering suits against it, and an appeal is pending. A different trial court also dismissed the securities action against it, and an appeal is pending. The plaintiffs voluntarily dismissed their ERISA action. The derivative actions are stayed until the securities appeal is decided. No Company D employees were accused of crimes.[1]

These four companies thus experienced widely divergent outcomes in relation to the Attorney General's investigation. In the most general sense, some of this disparity might have been foreseeable: for example, Company D might have had grounds to hope that it would achieve a better outcome than Company A, based on the allegations of the Attorney General's lawsuit as well as its knowledge of the documents it already had produced to the Attorney General in response to the subpoena. But *quantifying* the outcomes individually or in relation to one another would have been impossible *ex ante*.

Perhaps even more tellingly, four years down the road, very few of the private lawsuits precipitated by the Attorney General action have been resolved, and most remain subject to significant volatility. For example, the antitrust/racketeering suits (consolidated class actions involving all four companies as well as others) have been dismissed at the trial

[1] Numerous other public companies that were not mentioned in the Attorney General complaint against Company A also resolved disputes with the Attorney General related to the same industry practice for widely varying amounts and became embroiled in related private litigation. One non-public company refused to settle with the Attorney General, lost a motion to dismiss in the trial court, and won a partial dismissal on appeal.

level, but those dismissals are on appeal and could be reversed. There have been no rulings in the trial court on class certification, summary judgment, or evidentiary issues, and discovery is not yet complete. The claims seek unquantified compensatory damages, subject to potential trebling under the federal antitrust and racketeering statutes, as well as punitive damages. The range of potential outcomes is thus between zero and a large but indeterminate number. Four years after this family of legal proceedings began, these companies would be hard pressed to give a "best estimate" of the "maximum exposure to loss" with regard to any of them except those few that already have been resolved.

We have addressed this example at some length because we think it illustrates well the extremely uncomfortable position in which the proposed Statement would put issuers and their auditors. Responsible companies should not present estimates in their financial statements or the notes to their financial statements unless those estimates are factually supportable and have some predictive value. Making estimates on the basis of mere speculation about highly volatile outcomes that may be years away is not responsible, yet that is what the proposed Statement would require. Moreover, such estimates would be at best useless and at worst misleading to investors, because they would appear to be as reliable as other accounting estimates, yet they would often bear no relationship to ultimate outcomes. Finally, there would be no basis on which an auditor could validate such an estimate, because it would not be based on facts or on assumptions about contingent events whose probability can be meaningfully assessed.

Conclusion: The current SFAS 5, which requires disclosure of an estimate of loss only when the reporting entity has a reasonable basis on which to make one, takes an appropriate approach to disclosure of litigation-related loss contingencies. Litigation outcomes are frequently difficult or impossible to quantify. An estimate should not be compelled without regard to whether the reporting entity has a reasonable basis on which to make a reliable, predictive estimate. If it appears that reporting entities are not disclosing estimates of loss when they have a reasonable basis on which to do so, the appropriate response is enforcement of the existing Statement, which already requires an estimation in that circumstance. No purpose is served by imposing an obligation to disclose estimates of exposures that cannot be quantified with enough confidence to offer useful information to investors.

Point 2: Public disclosure of an entity's best estimate of its maximum exposure to loss in pending or threatened litigation is virtually always prejudicial. Optional disclosure of an entity's best estimate of the possible loss or range of loss compounds the prejudice.

Litigation in the United States is adversarial. Each side seeks to present evidence that supports its theory of the case and refutes the other side's case. Information that suggests a defendant has liability to the plaintiff in a significant amount—such as the defendant's "best estimate of its maximum exposure to loss" in the case—is potentially extremely valuable to a plaintiff and extremely damaging to a defendant. A plaintiff's attorney could present such information to a jury as both an admission of liability and the floor for any award of damages.

Moreover, an overwhelmingly high proportion of civil suits filed in this country settle. Every pending or threatened lawsuit is therefore a platform for negotiation. It is fundamental to negotiation that knowledge is power: the more one party knows about the other party's perceptions of its risks and rewards, the greater opportunity the first party has to use that information to achieve a favorable result for itself to the detriment of the other party. (Anyone who has ever negotiated to buy or sell a house or a car knows this intuitively.) Inequality of information creates inequality of bargaining power. Because the proposed Statement applies to loss contingencies and not gain contingencies, by definition it creates an inequality of bargaining power between plaintiffs and defendants—even before one considers that a very high percentage of plaintiffs against public companies are individuals or non-public entities to which the same disclosure rules do not apply.

An entity's "best estimate of the maximum exposure to loss" quantifies its perception of its worst-case downside risk—extremely valuable information to its litigation adversary. This information often would not otherwise be known or knowable to the adversary. Before discovery, a defendant may have considerably more knowledge about its potential exposure than a plaintiff has. For example, a plaintiff may have filed a class action without knowing how large the class is, whereas the defendant may at least be able to estimate from its own records the potential size of the class. (The size of the class is a major determinant of the amount of exposure.) If the defendant were compelled to disclose that the potential class size is much larger than the plaintiff had anticipated, that would completely alter the settlement dynamic to the defendant's detriment.

The option given in the proposed Statement to disclose the entity's "best estimate of the possible loss or range of loss if it believes that the amount of the claim or assessment or the maximum exposure to loss is not representative of the entity's actual exposure" compounds the problem. If the entity elects not to provide such a "best estimate of the possible loss," it may appear to be confirming that the "best estimate of the maximum exposure to loss" is "representative of the entity's actual exposure." But if it does provide such a "best estimate of the possible loss," it is quantifying its perception of a reasonable outcome or range of outcomes. If it makes that disclosure, it is a virtual certainty that it will not be able to settle the claim for less than the disclosed "best estimate" (or, if the best estimate is a range, the top end of the range). (Again, this is common sense; if you tell a car salesman that you think a fair price for the car is $24,000, you no longer stand any chance of buying the car for less.)

> *Example 2:* Company X, a public company, is sued by a small, non-public company, Company Y. The claim is for an indeterminate amount, but Company Y contends that it exceeds several billion dollars. Although Company X has considerable experience with claims of this kind,[2] this particular claim is

[2] The real lawsuit on which Example 2 is based sought benefits under policies of insurance issued by Company X, an insurer. Such liabilities are beyond the scope of the proposed Statement. Nonetheless, because of the size and volatility of the claim, Company X disclosed the matter as if it had been subject to

unusually volatile: legal rulings over the course of the case could swing the outcome anywhere from a $0 liability to a liability that might compromise its liquidity. Company Y understands, of course, that it is seeking a great deal of money, but does not understand Company X's precise economic and regulatory pressure points. The market does, however, understand that a multi-billion-dollar loss would jeopardize Company X's survival.

Under SFAS 5, Company X discloses the claim and describes it in sufficient detail to convey to the investing public the nature of the claim, how it arose, the contractual basis for it, its status, and its potential seriousness, including facts and allegations suggesting potential for an exposure exceeding a billion dollars. Company X states that the outcome is highly uncertain due to many factors, some of which its lists, and adds that, "[i]n the opinion of management, an adverse outcome could have a material adverse effect on the Company's results of operations, financial condition and liquidity."

Despite the volatility of the claim, its size causes Company X to believe it would be prudent to accrue for the estimated loss. Company X's lawyers advise that the realistic settlement value of the case is between $700 million and $1.5 billion. Company X accrues on the low end of that range. Its accrual is aggregated with other significant loss contingencies in its financial statements.[3]

About fifteen months after the initial disclosure, and following hard-fought litigation between the parties in three different courts, Company X settles the claim for $1.15 billion. The stock price does not move materially upon the announcement of the settlement.

Analysis: First, the lack of market reaction to a very large settlement suggests that Company X's disclosure under current SFAS 5 standards was adequate to convey the seriousness of the exposure. Requiring a reporting entity to quantify its exposure is not necessary to inform investors that the entity faces a significant risk.

Second, this case threatened Company X's survival as a going concern. It was therefore critically important to Company X's investors that the company be able to achieve as successful a resolution of the claim as possible. But if Company X had been required to quantify the claim in its disclosures in the manner required under the proposed Statement, its defense would have been materially compromised.

If Company X had been forced to disclose its "best estimate of the maximum exposure to loss," it likely would have felt compelled, in light of the volatility of the claim, to make

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the disclosure requirements of SFAS 5, and we think the example serves to illustrate some of our concerns about the proposed Statement in ways that are not unique to the insurance context.

[3] In the real situation on which Example 2 is based, the accrual was accounted for in Company X's loss reserves for the relevant category of insurance claim, which the company carried at the approximate mid-point of the actuarial range. Because the loss reserves were very large in the aggregate, the amount of the accrual for Company Y's claim could not be determined from the financial statements.

an estimation of several billion dollars. This would have immediately changed the settlement dynamic. It was essential to Company X's negotiating position that it not admit any realistic possibility of so dire an outcome. Presenting such an outcome in its public disclosures as its "best estimate of the maximum exposure" would have completely undermined that position.

Moreover, disclosing a potential exposure of several billion dollars would have drawn immediate pressure from investors, regulators, and rating agencies—even though the estimate was at that point no more than one hypothetically possible outcome among many. Company X therefore would have been prudent, if operating under the proposed Statement, to disclose also "its best estimate of the possible loss or range of loss." It had estimated the loss for accrual purposes at $700 million – $1.5 billion and thus likely would have disclosed that range as its "best estimate of the possible ... range of loss." Such a disclosure would have signaled to the plaintiff that Company X considered a settlement of up to $1.5 billion to be a reasonable outcome. In that circumstance, it would have been all but impossible for Company X to settle, as it ultimately did, for $1.15 billion; the plaintiff would have held out for at least $1.5 billion, costing Company X at least an additional $350 million.[4]

The potential for prejudice is not limited to the quantitative information required under the proposed Statement. The requirement that a reporting entity also disclose its "qualitative assessment of the most likely outcome of the contingency" and its "significant assumptions in estimating ... and in assessing the most likely outcome" would also seriously compromise a reporting entity's defense. Here, for example, Company X knew that it would be irresponsible to take the case to trial because a loss would be devastating to its business, harming not only shareholders but thousands of customers and employees. But to achieve the best possible settlement outcome, it had to give Company Y the impression that it was committed to scorched-earth litigation and prepared to try the case. It could not have maintained that posture if it had publicly disclosed that it thought the most likely outcome was settlement. Nor could it have stated the "significant assumptions" it made in estimating the loss without revealing that it expected the matter to settle. In addition, as discussed in Point 3, these disclosures would necessarily expose the otherwise privileged and confidential advice and opinions of the reporting entity's defense counsel.

In contrast, the *factual* qualitative disclosure required under the proposed Statement—such as "a description of the contingency," "how it arose," "its legal or contractual basis," "its current status," and "factors that are likely to affect the ultimate outcome"—is both informative to investors and not prejudicial to the entity. Indeed, Company X voluntarily included this factual background in its disclosure. That disclosure, coupled with words making clear that an adverse outcome could be material to Company X's financial condition and liquidity, was sufficient to set the market's expectations so that the ultimate outcome was not a surprise.

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[4] Disclosure of the range would also have set the floor for any negotiation at $700 million. In the actual situation on which this example is based, Company X's opening bid was hundreds of millions less.

Conclusion: Disclosure of an entity's "best estimate of the maximum exposure to loss" would virtually always be extremely prejudicial to the entity's defense of the matter it is disclosing. Allowing the entity also to disclose "its best estimate of the possible loss or range of loss" would exacerbate the prejudice by putting the entity to a Hobson's choice between disclosure of its best judgment as to the expected outcome (undermining any chance it might otherwise have to achieve a better outcome) or tacit confirmation that the estimated maximum exposure is "representative of the entity's actual exposure." Disclosure of an entity's "qualitative assessment of the most likely outcome" and its "significant assumptions" would also impede its defense. A disclosure regime that worsens litigation outcomes for reporting entities would harm their current securities holders and chill investment in American registrants. Moreover, this prejudicial disclosure is unnecessary to achieve the Board's aims. Enhanced qualitative disclosure of facts pertinent to the claim would be substantially less prejudicial, yet still sufficient to convey to the investing public the potential impact of an adverse outcome.

Point 3: The proposed Statement would compel the disclosure of otherwise privileged attorney-client communications and attorney work product, further compromising the interests of the reporting entity and its investors.

Neither the quantitative disclosures required under the proposed Statement nor the entity's "qualitative assessment of the most likely outcome of the contingency" could be developed responsibly without the advice and opinions of the counsel representing the entity in the litigation. Counsel's advice and judgment about the suit ordinarily would be protected from disclosure by the attorney-client privilege, the work product doctrine, or both. As discussed in the comment letter submitted by the American Bar Association, to which we commend the Board's attention, these protections are central to American jurisprudence and underlie parties' ability to defend themselves effectively and make informed and responsible judgments in our adversarial legal system.

Compelled waiver of these protections for the purpose of making the disclosures required under the proposed Statement would be prejudicial in multiple ways. First, as explained in Point 2 above, the disclosure itself would be prejudicial to the entity in the litigation. Second, because the disclosure has required the entity to waive a privilege that it otherwise would have been able to assert, the entity's litigation adversary may be able to use the disclosure as a tool to obtain even more otherwise privileged information pertinent to the case. Under the doctrine of subject-matter waiver, a party cannot selectively waive the attorney-client privilege with regard to some communications about a particular subject matter and not others. *See, e.g.*, 8 J. Wigmore, *Evidence* § 2328, at 638 (McNaughton rev. 1961). Accordingly, if the reporting entity is deemed to have waived attorney-client privilege for the purpose of complying with its disclosure obligations, the litigation adversary may be able to argue that it thereby has waived the privilege with regard to all confidential communications relating to the same subject matter. If successful, such an argument would open up the files of the reporting entity's attorneys to its litigation adversary—including, for example, counsel's analysis of weaknesses in the entity's case. This outcome would be extremely detrimental to the reporting entity's defense.

Further examination of Example 2 above may help to illustrate this point.

> *Example 2a.* As noted in Example 2, for internal purposes Company X's lawyers have evaluated its exposure in the lawsuit and quantified the settlement value of the case as between $700 million and $1.5 million. Company X has accrued a reserve at the low end of the range. The accrual is aggregated with other reserves in Company X's financial statements and cannot be isolated.
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> In the course of the litigation, Company Y's lawyers embark on a concerted campaign over a period of months to discover how much Company X has accrued for the case and the basis for the accrual. Their objective is at least two-fold: (1) to persuade the court that Company X "knows" it "owes" at least the amount of the accrual and therefore is acting in bad faith in denying any liability; and (2) to use the accrual as a floor for any negotiation. Company X asserts that the amount of and basis for the accrual are privileged because they are based on the advice of the company's counsel. The court ultimately upholds the claim of privilege with regard to the amount, which Company X has never disclosed. Because Company X has made public statements about its reserving methodology, however, the court permits discovery into the manner in which Company X sets reserves of this kind. As a result, Company X's chief litigation lawyer is deposed on the company's reserving methodology for like claims.

Analysis: The dogged persistence of Company Y in seeking discovery of Company X's internal valuation of the claim underscores the value that such information has to a reporting entity's litigation adversary (and consequently the prejudice to the entity from disclosing it). The outcome of the dispute illustrates the risk that a reporting entity takes when it discloses anything about these matters. The court deemed Company X to have waived any privilege that might otherwise have attached to the manner in which it determined how much to accrue for claims of the same nature. If Company X had disclosed the amount of the reserve as well, or the assumptions that it made in determining this particular reserve, or its qualitative assessment of the most likely outcome, that likely would have opened up to discovery all of the advice and analysis of Company X's lawyers regarding the potential outcomes and their relative likelihood. This would have seriously compromised Company X's defense in a "bet-the-company" case.

Conclusion: Disclosure that cannot be made without exposing the judgments and advice of counsel would be extremely prejudicial to a reporting entity, with potentially far-reaching consequences in the case because of the risk of a broad waiver of attorney-client privilege. Disclosure of a reporting entity's "best estimate" of loss or its "qualitative assessment of the most likely outcome" should not be compelled.

Point 4: The inherent volatility of litigation in United States courts, rather than inadequate disclosure, is the usual cause of investor surprise about litigation outcomes.

We do not doubt that sometimes investors are surprised by a huge verdict or other adverse outcome that was not foreshadowed in a company's financial disclosures. That does not necessarily mean, however, that the disclosures (much less the disclosure regime) were inadequate. It may mean that the company experienced a runaway verdict or other unanticipated result. Such outcomes are not infrequent in our legal system, but they are difficult to predict. Changed disclosure rules will not change the jury system, nor will they change the availability under our law of non-economic damages (such as pain and suffering) and punitive damages whose sole measure is the subjective judgment of a jury. Low-likelihood but high-impact events will continue to occur under any disclosure regime.

> *Example 3:* Company 1, a small limited liability company, sues Company 2, a public company, for patent infringement, theft of a trade secret, and breach of a nondisclosure agreement. Company 2 counterclaims, claiming that it was the owner of the alleged trade secret. Company 2's management believes, based on counsel's analysis of the case, that the claim presenting the most exposure is the patent claim, and that even if Company 1 could show infringement of the patent, it cannot prove damages in a material amount. Believing that the suit does not present a reasonable possibility of a material loss, Company 2 does not disclose it. This decision appears to have been well-founded when, a month before trial, the court dismisses the patent claim.
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> The trade secret and breach of contract claims are tried to a jury. To Company 2's great surprise, the jury returns a verdict against it of $18 million on the trade secret claim and $118 million on the breach of contract claim. Company 2 is shocked not only by the size of the jury's award on the trade secret claim, but that the court has permitted the jury to award liquidated damages under the contract without any regard for Company 1's actual damages—which even the jury found to be only $18 million, not $118 million. In a Form 8-K filing, Company 2 discloses the verdict. The case ultimately settles for $80 million, which includes a release of the patent claim, the dismissal of which Company 1 has appealed. Although the verdict and the ultimate settlement were material for Company 2, they did not have a severe impact on its financial position, cash flows, or results of operations.

Analysis: Investors might well have been surprised by Company 2's disclosure of the trial verdict. Company 2's prior disclosures had given no intimation that this loss contingency existed. But Company 2's management was equally surprised by the verdict. Company 2 reasonably believed, based on its lawyers' advice, that a material loss from the lawsuit was only remotely possible. Company 2 thus would not have disclosed the lawsuit under either the current SFAS 5 regime or the proposed Statement. Although the proposed Statement would require disclosure of a loss contingency, regardless of the likelihood of loss, if it is "expected to be resolved in the near term" and the contingency "could have a severe impact" on the entity's "financial position, cash flows, or results of operations," this loss contingency still would not have been disclosed because the loss, although material, was not anticipated to be, and was not in fact, severe.

Conclusion: Surprising events occur in American litigation. But a disclosure regime should focus on events that have a reasonable possibility of occurring, not every conceivable outcome. (See Point 5 below.) That necessarily means that from time to time an event will take investors by surprise, because it has taken management by surprise. This is not evidence of a need for more disclosure; it is evidence of a volatile litigation climate.

We believe that the current SFAS 5 regime—perhaps supplemented by enhanced qualitative disclosure of facts about a claim—provides appropriate disclosure. If it appears that some companies are not complying with the requirements of SFAS 5, the remedy is more enforcement, not different rules. Quantitative disclosure that is not fact-based, reliable, or predictive and is prejudicial to the reporting entity does nothing to lessen the risks of litigation in American courts; it simply makes navigating them even more difficult for public companies, and consequently for investors.

Point 5: Requiring disclosure of remote contingencies is not useful to investors and is prejudicial to the reporting entity, even if the potential impact of the contingency is "severe."

Investors do not and should not make investment decisions on the basis of contingencies that have a remote likelihood of occurring. Requiring disclosure of such contingencies, even if the impact could be "severe," would increase the length of financial statements without increasing the quantity or quality of useful information. It might also generate confusion as to the likelihood of the potentially severe impact being disclosed.

> *Example 4:* Company L, a public company, is sued by Company T, another public company, for fraud. The basis for the suit is that Company L sold Company T a tax-advantaged investment product that turned out not to yield all of the tax benefits allegedly promised by Company L. Because Company T is a large, sophisticated entity that received advice from its own lawyers and tax advisors before purchasing the product, and that advice identified the risk that certain potential tax benefits of the product might be disallowed by the Internal Revenue Service, Company L believes the probability that Company T will prevail on its claim that Company L deceived Company T about the tax benefits and risks of the product is remote. Moreover, under the applicable statute of limitations, Company T's claim appears to have been brought too late. Applying current SFAS 5 requirements, Company L does not disclose the lawsuit. If Company T were to prevail, however, and be awarded all of the damages it seeks, the impact on Company L could be severe, because the IRS had disallowed tens of millions of dollars in deductions on Company T's tax return and forced it to unwind the investment.
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> Company L moves to dismiss Company T's lawsuit and believes it is probable that the motion will be granted. The court grants the motion and dismisses

Company T's claim. While the dismissal is on appeal, the parties settle for a nominal amount.

Analysis: If Company L had disclosed the litigation with Company T, as the proposed Statement would require it to do once it expected the suit to be resolved within a year, how would investors have benefited? Any investment decision based on the disclosure would have been a mistake. Of course, there was a remote possibility that Company L would not prevail, and an even more remote possibility that a damages award would be so high as to have a severe impact on Company L's financial position, cash flows, or results of operations. But, precisely because such an outcome is remote, investors betting that the remote outcome will occur will be taking the wrong bet most of the time. Accordingly, sophisticated investors are likely to disregard the information. Unsophisticated investors, on the other hand, may wrongly assume that, because the matter is disclosed and described as potentially severe, it ought to inform their investment decision-making. Because these unsophisticated investors may attach too much importance to a remote contingency, they are particularly vulnerable to taking the wrong bet systematically.[5]

To be sure, there may be rare circumstances in which a remote contingency would be material to a rational investor. This might be the case, for example, if a loss would be truly catastrophic, or if the probability of a severe outcome, while judged to be remote, is close to being reasonably possible. But in such circumstances, reporting entities already have a strong incentive to disclose. Such prophylactic disclosure protects the entity against a shareholder suit if the severe outcome were to materialize. We believe that allowing entities to exercise their own discretion with regard to disclosure of remote contingencies, taking into account both the probability of loss and the potential severity of outcome, will lead to better disclosure than the over-disclosure compelled by the proposed Statement. It does not make sense to treat a 0.1% probability event the same as a 20% probability event and a barely severe outcome the same as a catastrophic outcome.

Conclusion: Required disclosure should be limited to contingencies that are not remote.

Point 6: The proposed Statement would increase reporting entities' exposure to securities fraud litigation, because in hindsight a company's estimates of its exposure to loss would almost always be wrong.

Because American litigation is so volatile, a rule that required disclosure of an entity's estimate of its potential loss, even when the entity has insufficient facts on which to base

[5] We appreciate that the proposed Statement limits the obligation to disclose remote but severe contingencies to those expected to be resolved in the near term. This limitation creates operational difficulty for issuers, however, because it is often difficult to predict when a lawsuit will be resolved or how it might develop over the course of a year. Settlement opportunities may arise suddenly and unexpectedly; they may also vanish equally suddenly and unexpectedly. Court action is also unpredictable; a decision can come within minutes, days, weeks, months, or years after a hearing or argument. And, of course, if the entity expects the remote contingency to be resolved in the near term through settlement, the last thing that would be in its or its shareholders' interest would be to disclose at that time a remote chance that the outcome of the matter under negotiation could be "severe." (See Point 2.)

a reliable estimate, would yield estimates that subsequent events would prove in more cases than not to have been wrong—often to a material extent. Looking at the miscalculation in hindsight, with knowledge of those subsequent events, it may be hard to reconstruct the information gaps that led to the miscalculation. Events that have actually occurred tend to look *ex post* as if they were foreseeable, even if *ex ante* they were not. If a reporting entity has made its "best estimate" in good faith but turns out to have underestimated its loss to a significant degree, and the announcement of the actual loss coincides with a drop in the entity's stock price, the plaintiffs' securities bar has all the ingredients it needs to commence a securities fraud class action—an action that would lack any merit, but might be hard to get dismissed on an early motion, before a great deal of expense is incurred.

In Example 3 above, for example, if Company 2 had been a smaller company with a lower materiality threshold, it might have disclosed the suit with Company 1, but its estimate of its maximum exposure to loss, if it had been required to make one, likely would have significantly understated the exposure, because it did not foresee a verdict exceeding $100 million under any scenario. Although incorrect in hindsight, Company 2's underestimation would not have been motivated by an intent to deceive, and subjecting it to potential Section 10(b) liability would serve no deterrent purpose.

Conclusion: Inviting fraud-by-hindsight securities fraud suits against companies for what are, in effect, forward-looking statements about uncertain future events is inconsistent with disclosure law generally and does not increase the quality of information available to investors. It merely increases the risk and cost of participation in American capital markets. For this additional reason, the quantitative disclosures required under the proposed Statement are unworkable and unwise.

* * * * *

We hope that these illustrations are helpful in explaining the basis for our concerns about the proposed Statement. Below we seek to answer several of the specific questions posed by the Board and relate them to the discussion above. The numbering tracks that in the Exposure Draft.

1. Will the proposed Statement meet the project's objective of providing enhanced disclosures about loss contingencies so that the benefits of those disclosures justify the incremental costs? Why or why not? What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?

We do not believe the quantitative disclosures in the proposed Statement would meet the project's objective. Compelling reporting entities to estimate their exposure to loss when they have insufficient information on which to base an estimate would not enhance the quality of information available to investors about litigation loss contingencies. Rather, it would give the misleading impression that the reporting entity is able to quantify a loss

when in truth it can provide an estimate only on the basis of speculation, not fact. (See Point 1 above.)

To comply with the proposed Statement, reporting entities (particularly those without large law departments or substantial litigation experience) would be compelled to incur increased counsel fees and quite possibly expert fees to develop estimates for disclosure. This expense would in most instances yield no benefit to the entity in the litigation itself. The damages evidence that the entity would develop for use in the case would be evidence that *minimizes* its exposure, not evidence of its *maximum* exposure. Because the proposed quantitative disclosures would be costly to prepare while providing no incremental benefit to investors, the benefits do not justify the costs—even before considering the prejudice to the reporting entity from the disclosures, which would result in far greater cost in the form of worse outcomes.

We believe that, in the main, the factual qualitative disclosures in the proposed Statement would not be unduly costly to prepare and would provide some incremental benefit to investors. We would recommend, however, that disclosure of "the entity's qualitative assessment of the most likely outcome" and its "significant assumptions" not be required. Such disclosure would often be prejudicial and would require entities to waive any attorney-client privilege or attorney work product protection that otherwise would attach to their qualitative assessment. (See Point 3 above.)

3. Should an entity be required to provide disclosures about loss contingencies, regardless of the likelihood of loss, if the resolution of the contingencies is expected to occur within one year of the date of the financial statements and the loss contingencies could have a severe impact upon the operations of the entity? Why or why not?

We do not believe that disclosure of remote contingencies should be required, regardless of severity. (See Point 5 above.)

4. Paragraph 10 of Statement 5 requires entities to "give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." One of financial statement users' most significant concerns about disclosures under Statement 5's requirements is that the disclosures rarely include quantitative information. Rather, entities often state that the possible loss cannot be estimated. The Board decided to require entities to disclose the amount of the claim or assessment against the entity, or, if there is no claim or assessment amount, the entity's best estimate of the maximum possible exposure to loss. Additionally, entities would be permitted, but not required, to disclose the possible loss or range of loss if they believe the amount of the claim or assessment is not representative of the entity's actual exposure.

a. Do you believe that this change would result in an improvement in the reporting of quantitative information about loss contingencies? Why or why not?

We do not believe that the change would result in an improvement in the reporting of quantitative information about loss contingencies. SFAS 5 already requires disclosure of an estimate if one can be made. If one cannot be made, it should not be disclosed. Disclosures rarely include quantitative information because litigation is extremely volatile and often turns on the subjective judgments of a jury concerning non-economic loss. That is a feature of our existing litigation regime, not a problem with the existing disclosure regime. Forcing reporting entities to make up numbers when they cannot reasonably estimate their exposure to loss does not provide useful information to users of financial statements. (See Point 1 above.)

b. Do you believe that disclosing the possible loss or range of loss should be required, rather than optional, if an entity believes the amount of the claim or assessment or its best estimate of the maximum possible exposure to loss is not representative of the entity's actual exposure? Why or why not?

We do not believe that it should be required, nor do we think the proposed Statement should state it as an option. Entities always have the option to provide more disclosure than disclosure rules require if they believe additional disclosure would be helpful to users of their financial statements. Stating that the option is available "if an entity believes the amount of the claim or assessment or its best estimate of the maximum possible exposure to loss is not representative of the entity's actual exposure," however, puts the reporting entity to the Hobson's choice described in Point 2 above.

c. If you disagree with the proposed requirements, what quantitative disclosures do you believe would best fulfill users' needs for quantitative information and at the same time not reveal significant information that may be prejudicial to an entity's position in a dispute?

We believe that the current SFAS 5 strikes an appropriate balance. It provides that if an estimate can be made, it should be disclosed, and that if a loss is both probable and estimable, it should be accrued.

If the reporting entity's adversary has quantified its claim—which in our experience is the exception, not the rule—disclosure of the claimed amount would not be prejudicial to the entity because it is information already known to the adversary. The adversary's quantification would often exaggerate the real extent of the exposure, but the reporting entity can provide a more balanced picture through qualitative disclosure.

5. If a loss contingency does not have a specific claim amount, will an entity be able to provide a reliable estimate of the maximum exposure to loss (as required by paragraph 7(a)) that is meaningful to users? Why or why not?

As explained in Point 1, a reporting entity will rarely be able to provide a reliable estimate of the maximum exposure to loss until the end stages of the litigation, and perhaps not even then if non-economic damages are sought.

6. Financial statement users suggested that the Board require disclosure of settlement offers made between counterparties in a dispute. The Board decided not to require that disclosure because often those offers expire quickly and may not reflect the status of negotiations only a short time later. Should disclosure of the amount of settlement offers made by either party be required? Why or why not?

We agree with the Board's decision not to require disclosure of settlement offers. It is true that such offers may quickly be overtaken by events, either later negotiations or court rulings that change the scope of the dispute. In addition, settlement offers have widely varying informational value. Some offers may reflect a serious negotiation and therefore give a meaningful indication of ultimate outcome, whereas others reflect mere posturing by one party or another and convey no information about ultimate outcome.

8. This proposed Statement includes a limited exemption from disclosing prejudicial information. Do you agree that such an exemption should be provided? Why or why not?

We believe that the exemption is far too narrow. Disclosure of an entity's estimation is prejudicial not in "rare" instances, but in almost all instances, and aggregation will not cure the prejudice because most entities have few material matters to disclose at any given time. (See Point 2 above.) We recommend that quantitative disclosures not be required except to the extent already required under SFAS 5.

10. The International Accounting Standards Board (IASB) continues to deliberate changes to IAS 37, Provisions, Contingent Liabilities and Contingent Assets, but has not yet reconsidered the disclosure requirements. The existing disclosure requirements of IAS 37 include a prejudicial exemption with language indicating that the circumstances under which that exemption may be exercised are expected to be extremely rare. This proposed Statement includes language indicating that the circumstances under which the prejudicial exemption may be exercised are expected to be rare (instead of extremely rare). Do you agree with the Board's decision and, if so, why? If not, what do you recommend as an alternative and why?

The circumstances in which disclosure of an entity's best estimate of its maximum exposure to loss will be prejudicial are neither "rare" nor "extremely rare" but the norm. Disclosure of a reporting entity's internal valuation of its litigation exposure should not be required, except to the extent already required under SFAS 5.

11. Do you agree with the description of prejudicial information as information whose "disclosure . . . could affect, to the entity's detriment, the outcome of the contingency itself"? If not, how would you describe or define prejudicial information and why?

We believe that the description is appropriate. We have used the term "prejudicial" in this sense throughout this comment letter.

14. Do you believe it is operational for entities to implement the proposed Statement in fiscal years ending after December 15, 2008? Why or why not?

We do not believe that implementation in that time frame is operational. Reporting entities, their auditors, and their attorneys would need to work through the many difficult challenges posed by the rule before implementation. In particular, the so-called "Treaty"—the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information and the AICPA Statement on Auditing Standards No. 12—would need to be revisited. We recommend that the Board redeliberate on the basis of comments and field testing and, in the event it issues a Final Statement, make it effective for fiscal years beginning after the release date.

We appreciate the Board's attention to these comments and hope that they have been helpful in illustrating the very serious concerns we have about the quantitative disclosures required under the proposed Statement.

Very truly yours,

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