

**Board of Directors** DAVID E. DUKES\*

Columbia, South Carolina GREGORY M. LEDERER\*

LCJ President-Elect Lederer Weston Craig PLC

Cedar Rapids, Iowa

# LAWYERS FOR CIVIL JUSTICE

1140 Connecticut Avenue, N.W. • Suite 503 • Washington, D.C. 20036 Phone: (202) 429-0045 • Fax: (202) 429-6982

July 23, 2008

Ms. Stacy Sutay Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

LETTER OF COMMENT NO. 10

Lewis F. Coulins\* LCJ Vice President Butler Pappas Weihmuller Katz Craig LLP Tampa, Florida

LCJ President Nelson Mullins Riley & Scarborough LLP

JEFFREY W. JACKSON\* LC1 Secretary-Treasurer State Farm Mutual Automobile Insurance Company Bloomington, Illinois

JULIA L. BRICKELL Altria Corporate Services, Inc. New York, New York

KIMBERLY M. DAVIS Washington, DC

THEODORE M. FROIS\* Exxon Mobil Corporation Houston, Texas

FAYE A. GRAUI Dow Corning Corporation Washington, DC

THOMAS H. HILL General Electric Fairfield, Connecticut

TOHN K. KIM Johnson & Johnson New Brunswick, New Jersey

IAN D. KOHANE urwitz & Fine, P.C. duffalo, New York

CONNIF LEWIS LENSING Federal Express Corporation Memphis, Tennessee

PATRICK A. LONG Long Williamson & Delis Santa Ana, California

L. GINO MARCHETTI Taylor Pigue Marchetti, PLLC Nashville, Tennessee

JOHN H. MARTIN Thompson & Knight LLP Dallas, Texas

WAYNE B. MASON Sedgwick, Detert, Moran & Arnold Dallas, Jexas

ROBERT E. NORTON, II DannlerChrysler Corporation Aubum Hills, Michigan BRUCE R. PARKER

Baltimore, Maryland

G. EDWARD PICKU. Shell Oil Company Houston, Texas

WRITAM J. RUANE\* Madison, New Jersey

SAMINA R. SCHEY General Motors Corporation Detroit, Michigan

MARC E. WILLIAMS Huddleston Bolen Huntington, West Virginia

Board Chauman Wil LIAM C. ROFDDER, JR.\* McDowell Knight Roedder & Sledge, LLC Mobile, Alabama

File Reference No. 1600-100, Disclosure of Certain Loss Contingencies

Dear Ms. Sutay:

We are pleased to submit these comments on behalf of Lawyers for Civil Justice, DRI, Federation of Defense of Corporate Counsel, International Association of Defense Counsel and the Association of Defense Trial Attorneys. LCJ is a national organization of corporate counsel and defense attorneys dedicated to improving the civil justice system, LCJ's membership consists of in-house corporate counsel, outside defense counsel, and the leadership of the DRI, Federation of Defense & Corporate Counsel, and the International Association of Defense Counsel. LCJ has long promoted consideration of issues that directly impact the problems confronting the civil justice system and has always sought to work with other members of the legal community to achieve fair and reasonable solutions.

Accordingly, we believe it is imperative to comment on the Board's Exposure Draft regarding disclosure of certain loss contingencies. Our adversarial litigation system depends on a delicate balance of information available to each side. This balance is established in civil procedure rules and court opinions that have been crafted by generations of experience. The proposed amendments in the Exposure Draft would dramatically shift that balance to the detriment of reporting entities. We therefore respectfully request that the Board reconsider the application of the new disclosure requirements to litigation contingencies.

#### Litigation creates unique loss contingencies.

Loss contingencies created by litigation are unique in several respects. First, the potential loss is extremely difficult to estimate, especially at the outset. An ultimate outcome often depends on factors outside the entity's or its counsel's control. For example, the outcome may be impacted by changes in common law, statutes, or regulations. Additionally, the outcome will be affected by decisions made by the court throughout the course of the

<sup>&</sup>quot;xecutive Director MRRY BALMAN

<sup>\*</sup>Member of the Executive Committee

litigation regarding venue, choice of law, scope of discovery, class certification, viability of claims and defenses, admissibility of expert opinions, and admissibility of other evidence. These decisions depend on many variables and are difficult to predict. For some decisions, the court has discretion to choose among a range of possible alternatives. Some of the decisions are subject to reconsideration by the court if circumstances change. Still other decisions (such as scope of discovery and admissibility of evidence) are dependent on how the court resolves issues such as class certification and viability of claims and defenses.

Even after the foregoing issues are resolved, the ultimate outcome may depend on a jury's verdict, which is even more difficult to predict than a judge's rulings. Due to the impact of the string of unpredictable decisions on the ultimate outcome, any effort to predict whether a particular case will result in liability or the extend of any such liability is necessarily inexact and subject to repeated re-evaluation throughout the litigation.

The Supreme Court of the United States recently addressed the inherent unpredictability of one aspect of jury awards: punitive damage awards. In Exxon Shipping Co. v. Baker, the Court considered the punitive damage award in litigation related to the Exxon Valdez oil spill in 1989. The Court noted that punitive damages awards by juries vary over a wide spectrum and suffer from "stark unpredictability." The Court could have made the same observation with respect to judicial determination of punitive damages. Over the almost twenty years of that litigation, successive court rulings set the punitive award at \$5 billion, \$4 billion, \$4.5 billion, \$2.5 billon, and finally \$507 million.

Additionally, the adversarial nature of litigation requires that internal evaluations of the claim be kept confidential. Prudence demands that a litigation defendant evaluate all potential legal theories and arguments that could be asserted by the plaintiff. Disclosure of this internal evaluation would prejudice the defendant's litigation position in several ways: (1) it may suggest legal theories and arguments to the plaintiff that the plaintiff had not considered; (2) the plaintiff could try to use the internal evaluation as an admission of liability or damages; and (3) the plaintiff could use the internal evaluation as leverage in settlement discussions.

As a result, virtually all jurisdictions in the United States protect such internal evaluations from disclosure. For example, Federal Rule of Civil Procedure 26(b)(3)(A) protects such work product from discovery in federal cases. One federal court has explained that this protection exists to "establish a zone of privacy for strategic litigation planning and to prevent one party from piggybacking on the adversary's preparation." U.S. v. Adlman, 68 F.3d 1495, 1501 (2nd Cir. 1995). This zone of privacy is essential to a litigant's ability to fully investigate a claim and to prepare and present a vigorous defense.

The proposed disclosure requirements would be costly to implement and are not likely to assist users of financial statements.

The Board has stated that the proposed disclosure requirements are intended to "assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies." The Board anticipates that the proposed new requirements "will improve overall quality of disclosures about loss contingencies by providing financial statement users with important information." But with respect to litigation related loss contingencies, the proposed requirements will be expensive to implement and will not likely provide helpful guidance.

As noted above, an evaluation of potential losses from litigation requires consideration of multiple variables. Fully analyzing all of the potential variables and their outcomes would require enormous expenditure of time and other resources. The Exposure Draft's requirement that the evaluation be updated quarterly would multiply the costs involved.

More significantly, the usefulness of the resulting estimate would not justify these costs. First, as noted above, any estimate of the amount of potential loss would rest on several shaky layers of unpredictable variables and assumptions. The underlying assumptions would have to be disclosed to make the estimate meaningful. But (as discussed more fully below), disclosure of the underlying assumptions would likely entail the disclosure of information covered by the attorney-client privilege or the attorney work product and would give the entity's adversary unjustified insight into the entity's view of the dispute.

Second, because of the difficulty of predicting the variables noted above, the resulting estimate is unlikely to be helpful. It may be accurate under a particular set of assumptions, but the accuracy of the assumptions themselves would be difficult to ascertain. Additionally, because of the layered nature of the variables, a change to one variable (either because an assumption is incorrect or because of court action), will have a cascading effect on the other variables and necessarily on the ultimate estimate itself.

Third, understanding the variables and the significance of the necessary assumptions requires specialized training in law and in other areas of expertise (such as accounting or statistics). Users without the necessary training could easily fail to appreciate the importance of particular variables or assumptions and misinterpret the information that is disclosed.

Because of these difficulties, the additional disclosure requirements regarding litigation are not likely to satisfy the Board's stated goals. Users of financial statements may believe that they are getting more complete disclosures, but in reality, the required additional disclosures will not provide a more accurate view of the potential loss than the disclosures currently required by FAS 5. Users will have nothing more than guesses based on layers of assumptions that are subject to change throughout the course of the litigation. Indeed, the disclosures proposed by the Exposure Draft may well provide an inaccurate view, especially at the outset of litigation, because of the many unpredictable variables. Such a view would hamper, rather than help, the user's understanding of the potential loss contingency.

### The proposed disclosure requirements may actually harm investors.

Beyond the difficulty of making an accurate evaluation of the litigation, the disclosures required by the Exposure Draft present a more direct threat to investors. The disclosures could impair the entity's ability to defend the litigation, thereby increasing the potential loss.

The proposed disclosure requirements pose an unjustified risk to the attorney-client privilege. United States law has long recognized that, with few exceptions, the communications between attorney and client must be inviolate. This communication privilege allows the party to provide its attorney with all necessary information to defend the litigation. It also allows the attorney to give the client candid evaluations of the possible outcomes of the litigation without fear that such evaluations will be used by the party's opponent. The candid exchange of information between attorney and client is essential to the attorney's ability to protect the client's interests.

The proposed amendments in the Exposure Draft pose four threats to this privilege. First, the qualitative disclosures are likely to be based, at least in part, on the evaluation and advice of the entity's attorney. Second, the entity may be required to disclose communications with its outside counsel to its outside auditors to support the qualitative disclosures. Third, the partial disclosure of the entity's communications with its outside counsel could result in a "subject matter" waiver of attorney-client privilege that would require a much broader disclosure of the entity's communications with its counsel. Fourth, if adopted, the amendments would have a chilling effect on the communications between attorney and client and thereby would impair the attorney's ability to defend the client's interests.

The proposed disclosure requirements would provide a party's litigation adversaries the party's internal evaluations of the dispute. Disclosure of this work product would put the entity at a distinct disadvantage. The entity's adversary would have access to the entity's evaluation of the claim without having to disclose its own evaluation. This one-sided transfer of information is the litigation equivalent of giving the enemy the high ground in battle. It would create a distinct disadvantage for the entity and impair its ability to defend against the claim. This, in turn, would result in harm to the entity's investors.

The ability to aggregate the disclosures by nature of the contingency does not address these problems. First, because litigation matters are largely fact specific, it is unclear how the qualitative disclosures would be aggregated. Second, many entities' litigation exposure is made up of one large claim or group of claims (such as mass tort litigation). In those instances, aggregation will not prevent the information from being used by the entity's litigation adversaries.

We recognize that the Board has also attempted to address these concerns by including an exemption for information that "could affect, to the entity's detriment, the

outcome of the contingency itself." The exemption allows aggregation of disclosures at a higher level, and, "in rare instances" permits the entity to withhold information. But this exemption for prejudicial information is inadequate. First, as noted above, the ability to aggregate will frequently be insufficient to protect prejudicial information. Second, even when the exemption is applied, the Exposure Draft states that

In no circumstance may an entity forgo disclosing the amount of the claim or assessment against the entity (or, if there is no claim amount, an estimate of the entity's maximum exposure to loss); . . . and providing a description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact on the outcome.

As detailed above, this is precisely the type of information that is otherwise protected from disclosure during litigation; therefore, this information could affect the outcome of the contingency itself. By requiring disclosure of this information in all cases, the Exposure Draft significantly limits the usefulness of the prejudicial-information exemption.

## The proposed disclosure requirements may also adversely impact the work of audit committees.

These same concerns apply to disclosures related to audit-committee investigations. Under Sarbanes-Oxley, audit committees of publicly-traded entities have wide-ranging authority to investigate and remedy wrongdoing by the entity's officers and employees. If an audit committee investigation results in a finding of wrongdoing, the proposed disclosure requirements could potentially apply to disclosures regarding the audit committee's findings. In addition to disclosures about the committee's findings and the action taken, the Exposure Draft could require the entity to disclose in detail any potential claims that could result from the wrongdoing.

This disclosure presents two key problems. First, it threatens the attorney-client and work product privileges discussed above. Second, it would require the entity to do the work of its potential litigation adversaries. The required disclosures would detail the potential claims and the potential damages and would essentially create a roadmap for anyone seeking to pursue a claim against the entity.

### Conclusion

In sum, the adversary litigation system in the United States carefully balances the need for disclosure and the need for confidentiality. Both sides in litigation are afforded the freedom to investigate theories and arguments without fear that they will aid their opponent. The proposed disclosure requirements in the Exposure Draft threaten this careful balance. An entity would be required to publicly disclose its own and its counsel's evaluations of the merits of the dispute. This disclosure would give the entity's adversary an unfair advantage in the litigation. At the same time, the litigation adversary

would be protected from disclosing its evaluation of the merits. The resulting shift in the informational balance would be harmful to the entity and its investors.

Therefore, we respectfully suggest that the Board except litigation-related loss contingencies from the application of the amendments in the Exposure Draft. The current disclosure requirements strike an appropriate balance among the need for disclosure of potential loss contingencies, the uncertainty of litigation, and the need to protect internal evaluations of those uncertainties from disclosure to litigation adversaries.

Sincerely,

Gregory M. Lederer, President Lawyers for Civil Justice

Kevin Kelly, President

Association of Defense Trial Attorneys

John H. Martin, President

Vayne B. Mason, President

rederation of Defense and Corporate Counsel

Robert D. Trunter, President

International Association of Defense Counsel

cc: Joe Damico

Technical Director