



LETTER OF COMMENT NO.

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August 8, 2008

VIA E-MAIL (director@FASB.org)

Technical Director
Financial Accounting Standards Board
File Reference No. 1600-100
401 Merrit 7
P.O. Box 5116
Norwalk, CT 06856-5166

Re:

Exposure Draft

Proposed Statement of Financial Accounting Standards

Disclosure of Certain Loss Contingencies

an amendment of FASB Statements No. 5 and 141(R)

(the "Exposure Draft")

Dear Technical Director:

The Exposure Draft referenced above invites interested parties to comment on the Exposure Draft. In accordance with said invitation, this letter is being submitted to the Technical Director by August 8, 2008, pursuant to the instructions included in the Exposure Draft.



Exposure Draft Background. The Exposure Draft purports to replace the disclosure requirements in FASB Statement No. 5, Accounting For Contingencies ("FASB No. 5"), for loss contingencies that are recognized as liabilities in a statement of financial position and for unrecognized loss contingencies that would be recognized as liabilities if certain criteria for recognition were met. As proposed, the Exposure Draft would significantly expand required disclosures about loss contingencies.

<u>Summary of Concerns About the Exposure Draft</u>. It appears that the objective of the Exposure Draft is to improve disclosure with respect to loss contingencies. As a general statement, it is impossible to disagree with this objective. As lawyers, however, we have a number of concerns with respect to issues that the Exposure Draft raises.

The Exposure Draft requires quantitative and qualitative information for virtually every piece of litigation, and even potential claims, since it is nearly impossible in most circumstances to determine that the likelihood of loss is "remote" for such loss contingencies. As such, we believe that the Exposure Draft: (1) asks financial statement issuers to, at great expense, quantify the unquantifiable; (2) will lead to misinforming investors and other financial statement users; and (3) will do irreparable damage to the attorney-client and work-product privileges (while at the same time causing harm to attorney-client and attorney-auditor relationships). We also believe that attempting to quantify the unquantifiable will inevitably result in more litigation.

The American Bar Association has already submitted comments to the Exposure Draft. The Concerns about the Exposure Draft raised in the comment letter submitted by the American Bar Association include, among others: (1) the Exposure Draft does not adequately take into account the unique nature of the United States legal system (i.e., the required disclosures: are unrealistic and extremely difficult to prepare; will seriously disadvantage defendants, without offsetting benefits for financial statement users; increase risks of privilege waivers; and are costly and time consuming, yet still subject to substantial risk of error); (2) the Exposure Draft's solutions with respect to prejudicial disclosures do not address the prejudicial disclosure problem; (3) the disclosures required by the Exposure Draft are difficult to audit and would increase erosion of privilege; (4) even limited disclosure of "remote" contingencies may change well-established definitions of materiality; and (5) quarterly reporting of changes in loss contingencies will lead to volatile, misleading, and prejudicial disclosures. While we certainly agree with the concerns about the Exposure Draft raised in the comment letter submitted by the American Bar Association, we feel this topic is important enough to provide our own comments.

We can certainly appreciate the goal of improving disclosure and recognize that investors and other users of financial statements may desire additional information concerning loss contingencies (as is likely the case for any number of other financial statement items as well). The Exposure Draft asserts that investors and other users of financial statements have expressed concerns that the disclosures about loss contingencies under the existing guidance of FASB No. 5 do not provide adequate information to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies. Since



these assertions appear to be entirely anecdotal, we feel compelled to ask whether there is any survey data, statistical analysis, or empirical information evidencing a failure to provide adequate and appropriate information about loss contingencies pursuant to the current disclosure regime. Absent well-established evidence demonstrating an overwhelming need for a change, we believe that continuing the current disclosure regime remains the best option. In addition to the current disclosure regime having the benefit of already being well understood, it respects, recognizes, and protects certain important aspects of the United States legal system as discussed in the comment letter submitted by the American Bar Association and in this letter. We respectfully offer these comments (which focus primarily on litigation as a loss contingency) for consideration.

Making the U.S. Legal System Work. In the United States of America, disputes are resolved through an adversarial system whereby each of the parties is represented by counsel and a judge or a jury determines the result. Because of the existence of third party decision makers, it is virtually impossible to predict the results of litigation or claims asserted with any certainty. By reading almost any newspaper virtually anywhere in the United States, one can discover litigation results which were unanticipated and surprising, not only to the public, but often to the plaintiff(s) and defendant(s) themselves. Given the foregoing, there are very few litigation proceedings in which the likelihood of a loss can be considered "remote." Therefore, the result of the Exposure Draft is to require the disclosure of certain quantitative information, a qualitative assessment of the most likely outcome, and the significant assumptions underlying the same, for virtually every litigation matter or claim. The Exposure Draft provides no opportunity (as the current disclosure regime provides) to say it is simply too early to offer an opinion, no ability to say the matter cannot be quantified at a point in time (even though that is most often the case), and very limited ability to avoid the required disclosures even when such disclosures are extremely prejudicial (due to the very limited exception for prejudicial information included in the Exposure Draft).

For our adversarial system to work as intended, it is imperative that clients be represented by attorneys who have the benefit of the attorney-client privilege and work product immunity, which, as we demonstrate below, will be undermined by the requirements of the Exposure Draft. In addition, the information required by the Exposure Draft may be admissible in litigation proceedings against financial statements issuers that are subject to the disclosure. Since the Exposure Draft requires a financial statement issuer to list the dollar amount of a claim involved or opine as to its value, such information will become admissions against interest used by an adverse party (e.g., the adverse party will claim: "The Defendant has already valued the claim at \$______ in its own financial statements."). In addition, preliminary evaluations of claims (often involving theories or potential damages not yet alleged by a plaintiff) will be in play. Likewise, communications preparatory to mediation, settlement conferences, and neutral evaluations will be in play. By virtue of obeying applicable court rules, scores of materials (some, or much, of which may be privileged) will be created that must then be supplied to the



auditor due to the requirements of the Exposure Draft. The protections of the Treaty¹ (as we discuss below) will no longer be available.

Moreover, litigation adversaries can use the disclosures required by the Exposure Draft to game the system. It is not hard to imagine plaintiffs timing lawsuits and/or seeking settlements based on the timing of their adversaries' completed interim or annual financial periods and the issuance of financial statements. Plaintiffs will also be able to extort settlements and influence juries with the information that is required by the Exposure Draft. The litigation process as we know it (including the willingness to discuss settlement, mediate, or otherwise resolve claims) will in such circumstances be irreversibly compromised. These consequences of the disclosure requirements set forth in the Exposure Draft are real, and (we assume) unintended.

Time-Consuming and Expensive. To be sure, any process by which one attempts to quantify litigation or claims asserted (each of which are often unquantifiable) will be extremely time-consuming and expensive for financial statement issuers, their attorneys, and their auditors. While we recognize that the Exposure Draft does not impose any obligations directly upon attorneys, responsible financial statement issuers and their auditors will demand that attorneys provide the information required by the Exposure Draft with respect to litigation and claims asserted. Obviously, it will be in the best interest of a financial statement issuer to make the best possible estimate with respect to the outcome of litigation. Financial statement issuers will, therefore, be required to undertake significant due diligence to provide the information required by the Exposure Draft. Such due diligence will of necessity require the involvement of attorneys and, often times, experts who are capable of providing some of the quantitative information the Exposure Draft requires. A necessarily time-consuming process results. As such, this question has to be asked: Since this process is an unscientific one, generating at best highly speculative information (that in an overwhelming majority of circumstances will turn out to be wrong), is it really worthwhile? No matter how much time and effort is spent in good faith by financial statement issuers and their attorneys, experts, and auditors, in attempting to quantify litigation, litigation results remain impossible to predict. This information gathering process will also have a negative impact on attorney-client relationships and the relationships between auditors, clients, and attorneys.

The costs of providing the information required by the Exposure Draft, given the necessary due diligence and the parties involved, will also be significant. To date, we have already experienced evidence of reluctance on the part of clients to pay for our responses to auditors inquiries. It stands to reason that clients will also balk at the costs (both time and money) the Exposure Draft will create. While the Exposure Draft indicates that the information required by it is already available, in our experience that is simply not the case. Any information that is given without appropriate due diligence and input of the appropriate parties (which necessarily comes with effort and cost), will be of little worth and will not meet the stated goals and objectives of the Exposure Draft. Updating the information required by the Exposure Draft

¹ The "Treaty": ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information, adopted by ABA Board of Governors in 1975; AICPA Statement on Auditing Standards No. 12, adopted in 1976 and supplemented up to 1998.



for interim financial statement periods (i.e., marking disclosures to market) will only exacerbate this problem, and will lead to volatile and, often, misleading information.

Attorney-Client Relations. The costs (both time and money) imposed by the Exposure Draft are merely one source of tension in the relations between attorneys and clients that the Exposure Draft will create. Again, responsible clients and their auditors will have to seek the input of their attorneys in providing the information necessary to satisfy the disclosure requirements of the Exposure Draft with respect to litigation and claims. Such information, even if it is privileged information, will be demanded in order for financial statement issuers (often under time pressure) to timely issue financial statements with the required opinions of the auditors. Saying no to clients will not be an option, as clients will find themselves under enormous pressure to issue their financial statements timely to avoid: violation of SEC requirements; default in credit arrangements; and/or other breaches of contract. Clients under the gun will be forced to cause their attorneys to provide privileged information to the auditors to meet the disclosure requirements of the Exposure Draft.

Clients will learn quickly that the Exposure Draft puts them between a rock and a hard place. Complying with the quantitative and qualitative disclosure requirements of the Exposure Draft will necessitate that financial statement issuers hand over information to auditors that will result in waivers of attorney-client privilege or work-product immunity. Information given to auditors will not enjoy privilege protection since "it is clear that in many situations auditor's responsibilities to the client and the investing public are dramatically opposed." Common law already exists suggesting that financial statement issuers and their auditors do not share 'common interests' in litigation and, as such, disclosures to the auditors do not serve the privacy interests that the work-product doctrine is meant to protect.³

Faced with the specter of loss of privilege, clients will become justifiably reluctant to communicate with their attorneys and their auditors to avoid being disadvantaged and prejudiced. The role of the auditor is an important one, but it should not come at the expense of waiver of privilege. The "valuable service of counseling clients . . . cannot be performed effectively if clients are scared to tell their lawyers what they are doing for fear that their lawyers will be turned into informants." Thousands of time a day lawyers all over the United States talk with clients in confidence under the secure protection of privilege allowing attorneys to advise their clients how to comply with the law. Armed with candid facts, attorneys are able to provide appropriate advice with respect to legal compliance. Based on such advice from their attorneys, clients choose to voluntarily comply with law without the need for SEC, PCAOB, or other governmental action. The high degree of voluntary legal compliance found in the U.S. legal

²Aaron J. Rigby, The Attorney-Auditor Relationship: Responding to Audit Inquiries, the Disclosure of Loss Contingencies and the Work-Product Privilege, 35 Sec. Reg. L.J. 1 (No. 3 2007).

³Medinol Ltd. v. Boston Scientific Group, 214 F.R.D. 113 (S.D.N.Y. 2002).

⁴United States v. Chen, 99 F.3rd 1495 (9th Cir. 1996).



system is deeply rooted in, and inextricably linked to, the attorney-client privilege. Because the Exposure Draft will inevitably cause disclosure of privileged information, perverse and insidious incentives are created for financial statement issuers <u>not</u> to communicate with their attorneys and/or auditors (ultimately undermining the functioning of the system).

Attorney-Auditor Relations. The Exposure Draft will also strain the relations of auditors and attorneys who have peacefully co-existed under that well understood détente, known as the "Treaty," for 30 years. Auditors, fearful of potential litigation with respect to the inherently speculative information that is required by the Exposure Draft, will seek as much information as possible from financial statement issuers and their attorneys and experts, including privileged information. Indeed, we are already seeing increasing numbers of requests for responses to auditors' inquiries which go well beyond the Treaty, including requests for confidential information falling within the protections of the attorney-client or work-product privileges. Currently, the Treaty protects such privileged information. Since the Exposure Draft does not appear to provide any exceptions for privileged information, it will eviscerate the protections of the Treaty. Strain in relations between auditors, attorneys, and clients will obviously result.

<u>Creation of More Litigation</u>. For various reasons touched on above, the Exposure Draft sets the groundwork for subsequent litigation not only against auditors, but also against clients and their attorneys and experts. When viewed in hindsight, the information required by the Exposure Draft will often be viewed as misleading and flawed. Because of the inherently speculative nature of the required information, no amount of good faith and due diligence can protect against this hindsight problem. Notwithstanding any caveats that might accompany the information required by the Exposure Draft, because such disclosures will almost always be incorrect, litigation with respect to such disclosures appears to be inevitable.

In addition, the Exposure Draft by its very terms leaves open many questions that set the stage for future litigation based on the new disclosures. How does one determine if the likelihood of a loss is "remote"? What do "expected to be resolved in the near term" and "could have a severe impact" on financial position really mean? How sure must a client be about the factors that are "likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome"? Which outcome is the "most likely outcome," and which assumptions with respect thereto are "significant assumptions"? Which disclosures "may" be prejudicial? These are extremely difficult questions which the Exposure Draft does not appear to adequately address. We believe these questions will only be answered after years of litigation that will undoubtedly result from the Exposure Draft asking for predictions where predictions are impossible.

We are also curious with respect to the expertise of auditors to review and audit the information required by the Exposure Draft, especially information with respect to litigation and claims. How can auditors know the appropriateness of, or in any way audit, the information required by the Exposure Draft? Do all auditors have the training and expertise to examine the validity of such information (since they will be required to do so)? Attorneys trained to handle litigation and claims often find themselves incapable of quantifying such matters and will often



have a very difficult time assessing the qualitative information required by the Exposure Draft. Given the foregoing, the expectations placed on auditors by the Exposure Draft seem to provide a playground for additional litigation as well.

Conclusion. Because the additional information required by the Exposure Draft is by its very nature speculative, it is difficult for us as lawyers to see the benefits of the Exposure Draft. That is especially the case since the current disclosure regime already provides a well-understood and time-tested means for handling loss contingencies, while protecting the very foundations of the U.S. legal system (especially the attorney-client and work-product privileges). FASB No. 5, as currently exists, at least recognizes that some of these matters are impossible to quantify (something the Exposure Draft overlooks). Any perceived problems with the implementation of the current disclosure regime can be handled by reinterpreting it if necessary. We believe that the existing disclosure regime, combined with state and federal securities laws, provides adequate disclosure to, and protection of, investors and other financial statement users.

If the changes set forth in the Exposure Draft are adopted, real damage to the United States legal system as we know it could result. The information required by the Exposure Draft will either result in a coerced waiver of privilege (i.e., clients demanding that privileged information must be turned over to auditors) or chill communications between clients and attorneys (so as to avoid privilege waivers). Neither of these results is acceptable. Clients will also be reluctant to participate in claim evaluation and settlement discussions for fear of prejudice. As discussed above, stressed relations between attorneys and clients are sure to develop if the Exposure Draft is adopted. In addition, attorney-auditor relationships will forever change as the Treaty will essentially go out the window. Finally, it seems impossible to deny that providing the quantitative and qualitative information required by the Exposure Draft will result in additional litigation when these mere predictions turn out to be incorrect.

We would like to thank you for your consideration.

Sincerely,

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