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HEDLUND & HANLEY, LLC

COMMERCIAL TRIAL AND APPELLATE LAWYERS

ROBERT F. HANLEY (1924-1991)

REUBEN L. HEDLUND
SARAH J. ISAACSON
JACK JOSEPH, OF COUNSEL

THE CHAMBERS - SUITE 4800
77 WEST WACKER DRIVE
CHICAGO, ILLINOIS 60601-1664
TEL: (312) 606-8610
FAX: (312) 606-8666

March 23, 2009

LETTER OF COMMENT NO. 241

Mr. Robert H. Herz
Chairman, Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Disclosure of Certain Loss Contingencies

Dear Mr. Herz:

While I realize that the deadline for comment on proposed revisions to FASB Statements No. 5 and 141(R) has long since past, I would hope the Board would take into consideration the enclosed comments during their redeliberations.

If there is anything further I can add, please let me know.

Very truly yours,

Reuben L Hedlund

REUBEN L. HEDLUND

RLH/jz

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Disclosure proposal raises constitutional issues

By Reuben L. Hedlund

In June of last year, the Financial Accounting Standards Board proposed amendments to Statement of Financial Accounting Standards Nos. 5 and 141(R) regarding disclosure of potential litigation losses. In the words of The Wall Street Journal, this "would be a gift ... to the trial lawyers, who will be able to use the information to extort settlements and influence jury verdicts."

In response to that and other criticism, the FASB instructed its staff to prepare and field-test "an alternative model," following which the board would hold public roundtable discussions on March 6, and schedule redeliberations for late March or April of this year.

As it now stands, the proposed requirements of FAS 5 and 141(R) include detailed disclosure of the assessment of the most likely outcome of pending litigation and a qualitative description of the factors likely to affect that outcome. These proposals are defended in the name of transparency, by FASB Chairman Robert H. Herz, "providing information earlier to existing and potential investors in order to give them a greater understanding of the risks companies face."

None of the disclosures proposed by the FASB can be accurately stated without the detailed advice and opinion of counsel representing the company in the disclosed litigation. That is why, following publication of the proposed amendments to FAS 5 and 141(R), the FASB received 240 comment letters, almost all unfavorable, criticizing the proposals as adversely affecting public companies' ability to defend litigation claims, and threatening the viability of the attorney-client privilege and work product doctrines.

Regardless of the amendments to FAS 5 and 141(R) ultimately decided upon, and unless the FASB abandons its proposals, reporting companies with significant litigation will be faced with the high cost and uncertainty of court battles with litigants over discovery of the opinions of counsel. Plaintiffs will contend that the defendant reporting entity, and its auditors, are required by law to make disclosures that rely upon the assistance and advice of legal counsel, and thus they are entitled to discovery of that advice. Further, because copies of the advice are routinely given to a third party (the auditing firm), the attorney-client and work product privileges are waived.

The recent 1st U.S. Circuit Court of Appeals decision in *United States v. Textron Inc.*, by a divided panel, illustrates the perils of relegating to the exclusive domain of the courts, governance of the attorney-client and work product privileges.

The question presented in *Textron* was whether those protections shielded from disclosure to the IRS, work papers prepared by the company and shared with its auditors in calculating tax reserve liability. Textron contended that the documents were prepared in anticipation of litigation with the IRS. The government responded that in order to comply with securities law, public companies prepare such papers every year, regardless of pending or expected litigation.

The majority of the three-judge panel in *Textron* ruled that documents prepared "because of" litigation are protected from disclosure, even if prepared in the "ordinary course of business," such as preparation of an 8-K, or management's discussion and analysis of the reporting entity's financial condition. Over a vigorous dissent, the majority in *Textron* held that such "dual purpose" documents are protected, although the law on this issue is far from settled. Equally unsettled by *Textron* is whether Textron's work papers in the possession of its auditors, or the auditors' work papers, are not protected from disclosure because such protections have been waived.

Disturbing to all but the plaintiffs' bar is the dissenting opinion in *Textron*, which rejected the "dual purpose rule" and argued instead for what it viewed as the prevailing law: "tax-accrual work papers are not protected because they are prepared for reasons independent of the need to prepare for or conduct litigation." Rehearing of the *Textron* decision by the full appellate court has been requested by the government.

However, if the proposed amendments to FAS 5 and 141(R) are adopted, reporting entities and their counsel may not have to wait to challenge the amendments until plaintiffs suing them demand discovery of the advice and counsel of the lawyers assisting in the disclosures mandated by the FASB. Late last year, a U.S. district court in Connecticut (*Connecticut Bar Association v. United States,* 394 B.R. 274) ruled that a Bankruptcy Code provision (§526(a)(4)) prohibiting attorneys from advising clients "to incur more debt in contemplation" of filing for bankruptcy, was an unconstitutional abridgement of the freedom of speech. This limitation on speech was found to interfere unnecessarily with a lawyer's duty of zealous representation and "may also work to deprive courts, as well as clients, of good counsel." Further, the court noted that freedom of speech guaranteed by the First Amendment also protects the rights of clients to receive advice from their attorneys, since "the Supreme Court has recognized the right to hear speech as well as the right to speak." In light of its conclusion that the Bankruptcy Code provision violates the First Amendment, the court chose not to rule on the claims that the provision also violated the constitutional rights to due process of law and equal protection.

Accordingly, in advance of the planned adoption of amendments to FAS 5 and 141(R), it should be pointed out to the FASB that those amendments violate the constitutional rights of both public companies and their litigation counsel. Freedom of speech, as recognized in *Connecticut Bar Association,* is an issue, as well as the principles of due process of law inherent in the right to rely upon the confidentiality of the advice and assessments of attorneys in defending civil claims.

Further, if the FASB goes forward with its proposals, and unless *Connecticut Bar* is overturned on the pending appeal, it would appear that reporting entities and/or their outside counsel have the right to file a constitutional challenge to enforcement of amendments to FAS 5 and 141(R), if adopted, and not wait until the issue comes up in litigation thereafter.

Those who would support the FASB proposals will argue that constitutional due process does not guarantee attorney-client or work product confidences, and that, even if it does, the government has an overriding interest in restricting those rights, and the decision in *Textron* was wrongly decided. Supporters will also contend that the attorney-client privilege and work product protections are based upon rules of evidence and discovery, which are best handled by the courts on a case-by-case basis, and that whatever the cost to reporting entities, it is outweighed by the benefits of transparency afforded to regulatory authorities, shareholders and the public in general.

The attorney-client privilege has its genesis in English common law beginning in the 17th century. It was quickly embraced by the courts in America, and then by the United States Constitution, but only with respect to defendants in criminal cases. In civil cases, whether involving private or governmental

litigants, the attorney-client privilege and its companion, work product protection, were classified merely as rules of evidence adopted from the common law, and enforced or denied by the courts on a case by case basis.

However, the founders of our nation chose to maintain the adversarial system of justice founded in England as well as due process of law, even though they rejected the routine award of attorney fees to successful litigants, and approved class actions. Under the rubric of "every person is entitled to their day in Court," America has become the most litigious community the world has ever seen. There are clearly extraordinary costs and inefficiencies attending to such a system, but so are the benefits of impartial (one hopes and strives for) resolution of disputes in a fair and just manner, and with the confidential assistance and advice of counsel.

In sum, the proposed FAS amendments, whatever they turn out to be, upset the current balance of rights between defendants and actual or potential plaintiffs, and damage our system of justice which, while not perfect, is a fundamental principle guiding preservation of the rule of law.

Reuben L. Hedlund is managing director of the law firm of Hedlund & Hanley LLC and is lead director and chairman of the nominating and governance committee of Unitrin Inc.
