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August 8, 2008

Technical Director
Financial Accounting Standards Board
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**Re: Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements
5 and 141(R) (File Reference No. 1600-100)**

Dear Director:

The Washington Legal Foundation (WLF) hereby submits these comments on the Exposure Draft released on June 8, 2008, by the Financial Accounting Standards Board (FASB) that would amend FASB Statement No. 5 and 141(R) requiring certain qualitative and quantitative disclosures of certain loss contingencies, including litigation, in a company's financial statements. For reasons more fully discussed herein, WLF believes that the proposed changes are unwarranted and could even mislead investors. Moreover, the disclosures would be difficult and costly to implement, result in unfair advantage to plaintiffs and their attorneys, and infringe on the company's attorney-client privilege. Accordingly, because the costs of the proposed standard outweigh any benefit, the revised FASB Statement No. 5 should not be adopted.

In any event, because of the significant impact this proposed accounting standard would have on reporting entities, WLF submits that any such standard cannot be and should not be made effective until after the Securities and Exchange Commission (SEC) has completed the rulemaking process under the Administrative Procedures Act, including notice and public comment, formally adopting the FASB standard.

Interests of WLF

WLF is a non-profit public interest law and policy center based in Washington, D.C., with supporters nationwide. Founded 30 years ago, WLF devotes a substantial portion of its resources to promoting a limited and accountable Government, supporting the free enterprise system, and opposing abusive enforcement actions by the Government and civil litigation by private litigants. WLF is submitting these comments as part of its INVESTOR PROTECTION

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PROGRAM. The goals of WLF's INVESTOR PROTECTION PROGRAM are comprehensive: to protect the stock markets from manipulation; to protect employees, consumers, pensioners, and investors from stock losses caused by abusive securities and class action litigation practices; to encourage congressional and regulatory oversight of the conduct of the plaintiffs' bar with the securities industry; and to restore investor confidence in the financial markets through regulatory and judicial reform measures. Additional information about WLF's INVESTOR PROTECTION PROGRAM is available on our website at www.wlf.org.

WLF has filed a number of comments with the SEC on matters of public interest. For example, on January 26, 2006, WLF filed comments on SEC Release No. 53025 (Dec. 27, 2005) regarding the distribution of moneys placed into seven Fair Funds as a result of a settlement by the SEC with seven New York Stock Exchange specialist firms. On April 30, 2003, WLF filed comments with the SEC in response to request for public comments on the two-day Hedge Fund Roundtable. WLF also filed comments with the SEC on February 26, 2007 in File No. S7-24-06: Management's Report on Internal Control Over Financial Reporting, 71 Fed. Reg. 77635 (Dec. 27, 2006). More recently, WLF filed comments on May 20, 2008 in File No. S7-08-08: SEC's Proposed "Naked" Short Selling Anti-Fraud Rule, 73 Fed. Reg. 15376 (March 21, 2008). Over the years, WLF has filed several complaints with the SEC requesting formal investigation of instances where there appeared to be a manipulation of the price of the stock by short sellers who were collaborating with class action and plaintiffs' attorneys.

WLF also litigates and appears as *amicus curiae* before federal courts in cases involving securities litigation. *See, e.g., Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005); *Merrill Lynch v. Dabit*, 126 S. Ct. 1503 (2006). WLF has also filed a brief in *Free Enterprise Fund v. The Public Company Accounting Oversight Board*, No. 07-5127 (D.C. Cir.) (pending) arguing that the PCAOB is unconstitutional because the manner in which board members are appointed and may be removed violates the Appointments Clause. WLF's Legal Studies Division has produced and distributed timely publications on the impact of Sarbanes-Oxley and securities regulations.

In addition to its INVESTOR PROTECTION PROGRAM, WLF has also established a CRIMINALIZATION OF FREE ENTERPRISE-BUSINESS CIVIL LIBERTIES PROGRAM opposing regulatory and enforcement actions that unfairly criminalize business activity. As part of that program, WLF recently published its SPECIAL REPORT: FEDERAL EROSION OF BUSINESS CIVIL LIBERTIES, which criticizes federal government enforcement policy and practices by the Department of Justice and regulatory agencies that assault civil liberties, including the attorney-client privilege, an issue which is implicated in the proposed FASB 5 as will be discussed further. In that regard, WLF also filed comments on July 15, 2008, with the General Services Administration opposing its proposed changes to Federal Acquisition Regulations (FAR) Case 2007-006. 72 Fed. Reg. 64109 (Nov. 14, 2007). That proposed rule would require government contractors to disclose certain information to the government that would

also threaten the attorney-client privilege.

The Proposed Changes to FASB Statement No. 5

Currently, FASB Statement No. 5 requires companies to make certain disclosures about loss contingencies where there is at least a “reasonable possibility” (defined as “the chance of the future event or events occurring is more than remote but less than likely”) that a loss has been incurred. Pending or threatened litigation, even if it is ultimately resolved in the company's favor, is considered a loss contingency that requires disclosure in financial statements. Disclosures indicate the nature of the contingency and provide an estimate of possible losses or range of loss or states an estimate cannot be made.

The proposed amendment to FASB Statement No. 5 changes the threshold for disclosures and the content of such disclosures. The proposed rule would require disclosure of *all* loss contingencies except those which are “remote” (defined as “the chance of the future event or events occurring is slight.”). Exposure Draft, ¶ 5. Nevertheless, even remote contingencies must be revealed if the contingency is expected to be resolved within the year and it could have a “severe impact on the company’s financial position, cash flows, or results of operation.” *Id.* at ¶ 6. Under the current standard, remote contingencies are never disclosed. Additionally, once a loss contingency qualifies for disclosure, the proposed rule requires quantitative and qualitative disclosures, which are not required under the current rule and will require a lot more information that will be difficult and costly to obtain.

The quantitative disclosures require companies to provide the amount of a claim or assessment against the company and, if there is no amount, an estimate of the maximum exposure. *Id.* at ¶ 7a. The company may disclose its best estimate of the possible loss or a range of losses if it believes the estimate better represents the company’s actual exposure. *Id.*

The qualitative disclosure requires the company to describe the contingency, how it arose, its legal or contractual basis, its current status, and the anticipated time of resolution. The company must also describe a multitude of factors which are likely to affect the outcome of the contingency and their potential effect on the outcome; assess the most likely outcome of the contingency; and describe the assumptions made in estimating the amounts disclosed and in assessing the most likely outcome. *Id.* at ¶ 7b. A qualitative and quantitative description is required of insurance or indemnification arrangements that may lead to recovery of some or all possible loss. The quantitative and qualitative disclosures may be aggregated by the nature of the loss contingency.

The proposed amendment has an unduly narrow exemption from disclosing prejudicial information for certain contingencies such as current or pending litigation. *Id.* at ¶ 11. Where disclosure of a contingency is prejudicial to the company’s position, where, for instance, the disclosure could affect the outcome of the contingency, the company may aggregate the

disclosures at a higher level such that disclosure is not prejudicial. Where aggregation fails to eliminate the prejudice, the company may forego disclosing the prejudicial information; however, the board expressed that, in its view, this would occur in “rare instances.” *Id.* In any event, the company must expressly state that it did not disclose the information and explain its reasons for doing so. *Id.*

There is no exemption for disclosing the amount or estimate of the claim or assessment against the company; or for providing a description of the loss contingency (how it arose, its legal or contractual basis, etc.); nor for providing a description of the innumerable factors that may affect the outcome of the contingency, along with the potential impact on the income of the company.

The Proposed FASB Statement No. 5 is Unwarranted

The FASB has stated that investors and other users of financial statements have expressed concerns that the present rule is inadequate to aid financial statement users in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies. Exposure Draft, Summary. However, WLF does not believe that FASB has made a compelling case that the current standard, which has been in place for over 30 years, does not provide adequate information to investors. In that regard, we agree with the comments filed by Allergan on July 16, 2008, that only a few vocal proponents, unrepresentative of the investor community, are advocating this change and that the FASB should fully disclose to the public the empirical information it possessed that prompted these proposed changes.

Additionally, as the Association of Corporate Counsel (ACC) noted in their comments filed on July 25, 2008, “[i]nvestors are not suffering from inadequate disclosures of litigation-related loss contingencies in financial statements.” Indeed, there are other sources, such as Audit Integrity, that provide the public with information about the costs of potential litigation against companies. WLF believes that the current disclosures are sufficient because they comport with the FASB’s mission, as stated in “Facts about FASB,” to focus “on the primary characteristics of relevance and reliability and on qualities of comparability and consistency.” The new rules, as discussed below, are likely to be very unreliable, irrelevant, and inhibit comparison and consistency in results.

Difficulties in Complying with the Proposed Rule

While the current rule is more than adequate to inform investors of the risks associated with loss contingencies relating to litigation, the proposed changes to the rule will provide little value and may even be misleading. Moreover, predicting the outcome of litigation is inherently complicated and unreliable. To win a case, a plaintiff must prove both liability and damages. A lawsuit where the likelihood of liability is great, but damages are minuscule or

unprovable, will have little impact on the company's financial position. Similarly, a case where there are substantial damages, but liability is remote or non-existent, will also likely have little impact on the company. The outcome of either of these two necessary predicates -- liability and damages -- in turn depends on dozens of other variables, including the admissibility of evidence, jury selection, the judge, the venue, trial strategies, case and common laws, the expertise of the attorneys involved, expert witnesses, third-party claims, and local rules of the court, to name just a few.

All of these factors play a large role in litigation outcomes and many of them are capable of changing during the course of the litigation and often do. As such, making an estimate of maximum exposure in regards to claims or assessments is a highly speculative guessing game that would be very misleading and likely inaccurate. Jury verdicts are highly unpredictable especially in claims involving products liability, class action lawsuits, and punitive damages, or where a damages amount may not have been stated in the complaint. This unpredictability of jury verdicts may be seen in cases like Exxon (jury punitive damages award of \$5 billion), McDonald's spilled coffee case (punitive damages of \$2.7 million), and the mixed verdicts in similar Vioxx cases.

Moreover, because of the venue or the judge, it may very well be that a company may lose a lawsuit, but is confident that an appeals court would overturn any judgment or a very large portion of it, such as the punitive damages award. As ACC points out in their comment, if these risks could be reliably estimated, it is likely that the companies would surely have settled their cases. Estimates of the possible amount of loss resulting from a lawsuit would not aid investors but instead would create confusion. Additionally, reliance on these misleading assessments would lead investors to make poor investment decisions with respect to that company. Requiring companies to describe all loss contingencies, including how they arose, their legal or contractual basis, the estimate on their resolution, and other predictions, would be highly speculative, would not aid the investor in making decisions, and as will be discussed, would infringe on the company's attorney-client privilege.

Not only is litigation unpredictable but the American court system lends itself to a very adversarial setting; thus, the disclosures of a company's best estimate of maximum exposure or even providing a range of possibilities provides valuable information to the plaintiffs and their attorneys. This kind of information could be used as an admission or it could become the floor demand in settlement negotiations. This disclosure regime may even be used as a way to essentially extort money from a company that a plaintiff knows would be willing to settle to avoid disclosing the potential obligation. This gives an unfair advantage to the plaintiffs because they have no reciprocal disclosure obligation. Furthermore, disclosures that later turn out to be inaccurate estimates could lead to further shareholder lawsuits for allegedly failing to accurately disclose the contingent liabilities. As the Wall Street Journal editorialized yesterday, "Estimate the possible liability too high, and the plaintiffs bar may extract more loot. Estimate too low and the company could get hit by shareholder suits questioning whether

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there was intent to mislead investors." WALL ST. J., *FASB's Lawyer Bonanza*, Aug. 7, 2008 at A12.

The proposed amendment would create other compliance problems. For example, the proposed rule would require a company to provide a reasonable estimate of its liability where there is no amount specified or demanded in the complaint. In such a situation, any estimate is likely to vary greatly between the company, the plaintiff, and the actual sum awarded. As noted, the proposed rule requires certain disclosures if there is any probability of success by the plaintiff that is more than remote, which encompasses a larger number of disclosures than under the present standard requiring disclosure only where there is a reasonable possibility that a loss has been incurred. Computing and evaluating both the quantitative and qualitative information required to be disclosed under the proposed rule is simply too burdensome, costly, and not likely to provide investors with necessary information. In that regard, WLF supports the excellent comments filed by the American Bar Association (ABA) on August 5, 2008, which discusses these evaluation problems in greater detail.

Erosion of the Attorney-Client Privilege

One of the more highly objectionable features of the proposed standard is the adverse impact that it is likely to have on the company's attorney-client and work product privileges. In brief, in order to comply with the proposed disclosure rules regarding litigation contingencies, a company will necessarily rely on the advice of its counsel, which, in turn, would publicly reveal privileged information and generate a claim by plaintiffs' attorneys that the company has thereby waived its privileges.

The attorney-client privilege, the oldest evidentiary privilege with historical common law roots in England from the 1500s, is designed to protect the disclosure of confidential communications between attorney and client. The privilege was originally limited to confidential communications between an attorney and individuals, but was later recognized to include communications between corporations and their attorneys. *See United States v. Louisville & Nashville R.R.*, 236 U.S. 318, 336 (1915).

Extending this privilege to corporations was particularly important inasmuch as the Supreme Court had ruled just a few years before the *Louisville* decision that corporations have no Fifth Amendment right against self-incrimination. *Hale v. Henkel*, 201 U.S. 43, 86 (1906). Without this constitutional protection, the attorney-client privilege is the only protection that corporations can invoke to protect certain forms of confidential communication within the corporate structure. Unfortunately, as then SEC Commissioner Paul S. Atkins candidly recognized, this privilege has been under attack by federal prosecutors and government agencies:

What is astonishing is that the attorney-client privilege, one of the foundational rights

on which rests Anglo-American legal culture . . . should now be under siege. The two federal agencies that have been most vigorous in seeking waiver of the attorney-client privilege have been the Department of Justice and -- unfortunately, I must say -- the Securities and Exchange Commission.

Remarks by Commissioner Paul S. Atkins before Federalist Society Conference, January 18, 2008.

Unfortunately, the proposed standard would further this erosion of the attorney-client privilege. As the ABA noted, in order to make the required qualitative and quantitative disclosures, privileged information from counsel must be sought. Furthermore, certain loss contingencies related to litigation may need to be audited by an independent auditor. To the extent that such an audit will result in the disclosure of privileged information, which is likely, this may result in the privilege being deemed waived. In such a case, plaintiffs' attorneys will have a field day seeking the disclosure of all related communications between counsel and the company, resulting in expensive collateral litigation. Once such confidential information is deemed waived and ordered to be released, plaintiffs' attorneys will clearly have an undue advantage over their targets in the underlying litigation.

Moreover, as the ACC aptly noted in its comments, "the potential effect of the proposed amendments on the work-product doctrine is perhaps even more problematic for in-house counsel than the proposed amendment's potential to erode the larger attorney-client privilege." ACC Comments at 6. That is so because it is the duty of in-house counsel to analyze and evaluate the merits of claims made against the company. Accordingly, if such information must be disclosed and tested by auditors, the mental impressions and judgments of the attorneys would be subject to disclosure. The unintended consequences of this proposed rule may very well chill communications between counsel and company officials, thereby undermining the very reason for the existence of both the attorney-client and work product privileges. Under either scenario -- that disclosure leads to waivers or chills communications between counsel and company officials -- the companies and their shareholders suffer in the long run.

Compliance with the Administrative Procedures Act

Finally, WLF submits that inasmuch as the proposed amendment would have a significant and substantial impact on the reporting community, any such rule adopted by FASB should and must be subject to formal rulemaking proceedings by the SEC under the Administrative Procedures Act (APA), with notice and comment, including public hearings, before the amendment can become effective.

Section 19(a) of the Securities Act of 1933, 15 U.S.C. § 77s(a), and Section 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(b), gave authority to the SEC to adopt

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accounting standards. The SEC was not authorized to delegate this governmental responsibility to private organizations such as the FASB. While it is true that Section 108 of the Sarbanes-Oxley Act of 2002 allows the SEC to recognize generally accepted accounting standards of certain organizations to "assist" the Commission, WLF submits that it is the SEC's legal responsibility to carefully examine major accounting standards and amendments thereto, such as FASB Statement No. 5, and to formally adopt them as the SEC's own. Since this proposed amendment would be a substantive rather than procedural rule, the SEC must engage in rulemaking as governed by the Administrative Procedures Act, 5 U.S.C. §§ 552, *et seq.* That would entail publishing a notice and comment in the Federal Register, and preferably holding public hearings because of the widespread public interest in this matter.

In that regard, WLF supports the Petition to the Securities and Exchange Commission for Review and Repeal of FAS 123R filed on February 27, 2008, by B. Kipling Hagopian and some two dozen noted economists and accountants, including two Nobel Laureates, that criticized the passage of FAS 123R, "Share-Based Payment," for new accounting procedures for employee stock options. That petition makes a compelling argument that the SEC is bound by APA before any substantive FASB accounting rule can be legally binding on the reporting community. At a minimum, the SEC should, as a matter of sound public policy, utilize the APA procedures when major FASB rules are being proposed or amended.

Conclusion

For the foregoing reasons and those provided in similar comments filed in this proceeding, WLF urges the FASB not to amend FASB Statement No. 5.

Respectfully submitted,

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cc: The Honorable Christopher Cox, Chairman
Securities and Exchange Commission