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**Morgan Lewis**  
C O U N S E L O R S   A T   L A W

August 5, 2008

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

Re: Disclosure of Certain Loss Contingencies - Amendment of FASB Statements  
Nos. 5 and 141(R) - File Reference No. 1025-300

Ladies and Gentlemen:

Morgan, Lewis & Bockius LLP, a global law firm with more than 1,400 lawyers and 22 offices, respectfully submits this letter to comment on certain aspects of the proposed amendments to the FASB statements referenced above, which we will refer to as the "Proposed Amendments". Our perspective is that of a large law firm with offices in major metropolitan areas in the United States and international offices in Beijing, Brussels, Frankfurt, London, Paris and Tokyo. Our firm has a broad-based business and litigation practice that includes the representation of large and small businesses, including more than half of the Fortune 100, in one or more practice disciplines spanning the full range of legal issues faced by American and international companies.

Our fundamental concern with the Proposed Amendments is that they seek to provide certainty in the amount and financial statement impact of loss contingencies at a point where certainty is not capable of being achieved. Rather than focus on known or reasonably estimable amounts, the Proposed Amendments will require businesses and their counsel to engage in speculation, conjecture and unwarranted assumptions. Moreover, the Proposed Amendments reflect a lack of appreciation for litigation dynamics and the adversarial justice system in the United States. The negative implications of the Proposed Amendments for the attorney-client and work product privileges would be an enormous disservice to businesses and their investors without any demonstrable benefits.

For more than 30 years, the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (the "ABA Statement") and the American Institute of Certified Public Accountants Statement on Auditing Standards No. 12 ("SAS 12"), commonly known collectively as the "Treaty", have provided a well-known, accepted and useful framework for audited companies and the legal and public accounting professions in addressing the disclosure and evaluation of loss contingencies identified in Statement of Financial

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Accounting Standards No. 5 (“FAS 5”). The Treaty strikes a delicate balance between the need for reliable information concerning material loss contingencies and a company’s (and its investors’) interests in defending claims and mitigating loss contingencies, including preserving a company’s entitlement to the protection of the attorney-client and work product privileges. We are concerned that the Proposed Amendments will eviscerate the Treaty and remove the protections of the attorney-client and work product privileges so carefully preserved in the Treaty.

Our recommendation with respect to the Proposed Amendments would be to make FAS 5 a principles-based standard, and the disclosure requirements should consist solely of requirements to disclose loss contingencies that are individually material or material when considered with related loss contingencies and that only the following information be disclosed:

1. A description of the loss contingency, including how it arose, its legal or contractual basis, the amount of any publicly asserted damage claim and the current status of the claim; and
2. Information that would provide as much quantitative and qualitative information as the disclosing entity can reliably provide about the risks that the loss contingency poses, including the potential and actual effects of the loss contingency on the entity’s financial position, cash flow and results of operations, without adversely affecting the disclosing entity’s ability to mitigate the loss or defend against the claim, and thereby to reduce or eliminate the loss contingency.

Unlike the civil law countries that serve as the context for the standards reflected in International Auditing Standard 37, “Provisions, Contingent Liabilities and Contingent Assets”, and on which the Proposed Amendments seem to be based, the American civil justice system is characterized by a large, well-organized plaintiffs’ bar, liberal discovery rules, the possibility of mass tort and class action cases with potentially large civil damage awards as well as the potential for punitive damages. At the commencement of a case, there is frequently a wide disparity in the valuation of a claim by the respective parties. In many cases, the parameters of the potential loss are not known for several years, and the ultimate resolution of a case may take many years and frequently are for amounts that bear little relation to the original claim. Moreover, the amount or even likelihood of punitive damages cannot be known until after a case has been tried and the underlying damages are established. Recently, the Supreme Court noted that punitive awards are unpredictable and can be very dissimilar notwithstanding similar facts.<sup>1</sup> For these reasons, the Proposed Amendments would not meet the project’s objective of providing enhanced disclosures about loss contingencies nor would the new disclosures justify the incremental costs of obtaining them.

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<sup>1</sup> See *infra*, Exxon Shipping Company, 128 S. Ct. 2605, at 2625 and 2626 (2008).

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Our more detailed comments follow:

1. If adopted, the Proposed Amendments would require disclosing entities to estimate the maximum exposure to loss, despite the fact that in many cases complaints filed in federal and state courts do not include an amount of damages sought against the disclosing entity.<sup>2</sup> These estimates would not provide reliable information to investors, and might even confuse or mislead investors, because disclosing entities would not be able to estimate with any degree of confidence the maximum exposure to loss resulting from many lawsuits, particularly in the early stages, for the following reasons, among others:
  - a. Until discovery is completed, a disclosing entity's lawyers do not complete their research into the facts, or expend significant effort consulting specialists, such as engineers or environmental specialists, until they know what damages the claimant has suffered and fully understand the claimant's theory of the case. Accordingly, a disclosing entity's lawyers would have no basis to estimate damages and would not know whether information learned by the claimant during discovery would affect the amount of damages or the outcome of the case.
  - b. The disclosing entity may not know whether a judge would let the case proceed in the form in which it was filed. For example, a judge may not agree that the case can be brought (a) individually or as a class action, and if a class action, what criteria will be applied to establish or limit the class, (b) in the particular place or under the particular state's laws, or (c) against the identified defendants.
  - c. The disclosing entity may not know whether a judge would agree to dismiss some or all of the allegations as not meeting the applicable legal standards or to admit particular evidence.
  - d. An estimate of the amount of damages that a court or jury may award is extremely difficult. Furthermore, damage awards arising from litigation can change drastically and unpredictably on appeal.<sup>3</sup>

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<sup>2</sup> For example, most class actions under federal and state securities laws do not state damages at the outset of the case. Typically, the only amount required to be specified in a complaint is a statement that the damages are in excess of the statutorily required minimum for that court. Frequently, such amount bears no relation to the damages allegedly incurred.

<sup>3</sup> For example, in its recent decision in Exxon Shipping Company v. Baker, 128 S. Ct., the Supreme Court reduced a \$2.5 billion punitive damages award to \$507.5 million by crafting a new common law rule for

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- e. The disclosing entity would not know how the law or interpretations of the law might change over time or how the outcome of similar litigation faced by others or political or other factors might affect the litigation. Often, litigation revolves on points of law that are unsettled and change while the litigation is pending.<sup>4</sup>
2. Calculating an estimate of the maximum exposure to loss would be a time consuming and costly process that would not likely result in a reliable estimate in most cases.
    - a. The time and costs of identifying and analyzing all of the factors that would affect an estimate, including technical issues requiring the assistance of specialists, would outweigh the benefits of the disclosure of the estimate to investors because of the lack of reliability. Disclosure of such a subjective and unreliable estimate would potentially mislead investors more than assist them in understanding the potential impact of the loss contingency.
    - b. The estimate is likely to change over the course of the litigation or government investigation, requiring explanations of the change, further expenditure of time and money to calculate the impact of new facts on the estimate, and potential litigation as to the reasonableness of the estimates disclosed over the course of the resolution of the contingency. The perceptions of claimants and the disclosing entity about a particular claim will change as discovery unfolds and each side develops its theory of the case. Claimants initially may file a claim for \$10 million, but ultimately settle happily for \$1 million, and a disclosing entity's initial valuation may be equally distorted, in either direction.
    - c. The new requirements likely would result in the inability of a disclosing entity to file with the Securities and Exchange Commission ("SEC") its

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punitive damages in maritime cases. The original punitive damages in the case, awarded by a jury in 1994, were \$5 billion, but this figure later was reduced to \$2.5 billion by an appellate court. At any point in the almost two decades of litigation, it would have been nearly impossible to foresee the final punitive damages amount.

<sup>4</sup> For example, the Supreme Court recently ruled in Stoneridge Investment Partners v. Scientific-Atlanta, 128 S. Ct. 761 (2008), that secondary actors who knowingly participated in transactions that helped a public company deceive its auditor and issue misleading financial statements could not be sued as primary violators under the antifraud provisions of the securities laws. As a result of the decision, other pending litigation that relied on the same "scheme theory" of liability rejected in Stoneridge suddenly became moot. See, e.g., Regents University of California v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 128 S. Ct. 1120 (2008).

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annual and periodic reports on a timely basis when the entity becomes aware of lawsuits or government investigations at a time close to when financial statements must be finalized, because of the need for the disclosing entity to consult specialists, such as engineers, environmental specialists, and lawyers, who would need to conduct investigations before they could provide reliable advice about the potential exposure.

- d. The estimates of the maximum exposure to loss and the tabular reconciliation of loss contingencies contemplated by the Proposed Amendments give no consideration to the likely timing of a claim's ultimate resolution or its cash flow implications. Estimates of loss contingencies at the inception of a claim will be far more uncertain, indeed conjectural, than estimates that can be made with more confidence after the completion of discovery and as a trial date approaches, yet both are given equal weight in the Proposed Amendments. The Management Discussion and Analysis portion of periodic reports and other filings is a far better vehicle for disclosing entities to discuss the future cash flow implications of pending claims and other "known trends or uncertainties".<sup>5</sup> Moreover, the timeframe of the typical MD&A disclosure is far more relevant to the users of financial statements than an aggregated tabular reconciliation of loss contingencies that gives no weight to timing considerations.
3. A radical change in the dynamics of litigation and an incredibly unfair advantage for the claimant would result from the Proposed Amendments requiring disclosing entities (a) to disclose the amount of the claim, if the amount is not set forth in a publicly filed complaint; (b) to estimate and disclose the maximum exposure to loss when no claim or assessment has been made against the disclosing entity, and (c) to disclose (i) the amounts of losses already recognized, (ii) the anticipated timing of the resolution of the contingency, (iii) the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the contingency, (iv) the entity's qualitative assessment of the most likely outcome of the contingency; (v) significant assumptions made by the entity in estimating the amounts disclosed and in assessing the most likely outcome,<sup>6</sup> (vi) qualitative and quantitative information about insurance and indemnification arrangements; and (vii) the tabular reconciliation of recognized loss contingencies.

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<sup>5</sup> See Item 303 of Regulation S-K.

<sup>6</sup> The proposal to permit a disclosing entity to disclose its "best estimate of the possible loss or range of loss" raises a question as to the meaning of the term "possible loss." If this provision is retained, we suggest that the FASB define this term to mean the "most reasonably probable loss."

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- a. A requirement that a disclosing entity disclose the amount of a claim or assessment when the claimant has not asserted the amount publicly would be difficult for a disclosing entity to implement because of uncertainty about the amount that the claimant subsequently might assert. In addition, disclosure of an amount suggested by officials in a government agency or other regulatory body, such as the SEC, before completion of the agency's approval process, would be inconsistent with that approval process.
- b. Disclosure of the amount of an accrued loss would affect the course of litigation. FAS 5 currently requires disclosure of the amount accrued, but only if that amount is material. Accordingly, most disclosing entities have not been disclosing the amount accrued. The adverse effects of disclosure of that amount, unless the amount itself is material to investors, would offset any benefit of the disclosure to investors because it likely would be used by a claimant as the "floor" in its damage calculation for settlement or trial purposes.
- c. Disclosure of the estimated maximum exposure amount would likely force settlements in cases that otherwise would await resolution in the normal course of the proceeding, frequently at a fraction of the maximum.
- d. Disclosures of other proposed information, including the tabular reconciliation of recognized loss contingencies, would enable claimants to understand the disclosing entity's assessment of the probable loss, thereby strengthening the claimants' negotiating position.
- e. Aggregation of these disclosures by the nature of the loss contingency would not help disclosing entities that have few lawsuits or other proceedings or that have cases that are unique or involve larger damage amounts than other loss contingencies of the same nature. Furthermore, since Item 103 of Regulation S-K and Item 1 of Part II of the Form 10-Q require public entities to disclose information about material pending litigation and government proceedings, other than ordinary routine litigation, including material developments in such proceedings during a quarter, claimants likely will be able to determine to what proceedings the estimates relate, even if the disclosing entity ostensibly aggregates the amounts.
- f. The exception from disclosing prejudicial information would not be sufficient for the same reasons that aggregation would not be sufficient. Moreover, the statement in the Proposed Amendments that disclosure would be prejudicial only in "rare instances" might result in auditors'

conclusions that the exemption is available in far fewer situations than disclosing entities believe are necessary.


4. The proposals to require disclosure of an estimate of the maximum exposure to loss when no claim or assessment has been made against the disclosing entity and provide information about the ultimate outcome of the contingency would fundamentally alter the relationship between disclosing entities and their counsel and likely result in the loss of the attorney-client privilege by the disclosing entity. The disclosing entity likely would consult its counsel regarding the nature of the claims, the strength of the disclosing entity's defenses and the likely outcome of the proceeding, and the disclosing entity's auditors would need to obtain the views of the disclosing entity's counsel as evidential support for the disclosures.
  - a. The auditors' need for evidential support would require a reconsideration of the Treaty by the ABA and the AICPA. Such a reconsideration also would need to include the Public Company Accounting Oversight Board, which, pursuant to the Sarbanes-Oxley Act of 2002, has the authority to establish auditing standards for entities that file registration statements or reports under the Securities Act of 1933 or the Securities Exchange Act of 1934.
  - b. The loss of the attorney-client privilege would dramatically change the dynamics of litigation in the United States. The protections provided by the attorney-client and work product privileges enable parties to consult unconditionally with their expert advisors to permit a candid assessment of the reasonableness of the claims and defenses, without fear that claimants could use that analysis to their advantage.
  - c. The loss of the attorney-client privilege might result in a disclosing entity's decision not to confide fully in its counsel, which would adversely affect the quality of any disclosures as well as the disclosing entity's ability to obtain competent advice and to defend itself properly.
  - d. The disclosure requirements for additional information contained in the Proposed Amendments, and the likelihood that auditors would require that information to be verified by counsel, would impose new requirements on lawyers and forever alter the lawyer-client relationship – and not for the better. Rather than serving as an advocate for our clients, the lawyer's role would become an adjunct to the auditor. The implications of such a change in the lawyer's role go far beyond the narrow confines of audited company disclosures.


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Lastly, we do not believe that the FASB's timeframe for considering the Proposed Amendments is adequate. As set forth above, the Proposed Amendments fundamentally alter the disclosure requirements for audited companies with respect to loss contingencies and have implications far beyond the requirements of FAS 5 and Statement of Financial Accounting Standards No. 141(R), "Business Combinations". The Proposed Amendments have not been field tested, and the implications of the Proposed Amendments on the reliability of loss estimates have not been examined. Moreover, the implications of the Proposed Amendments for the Treaty have not been fully examined by the sponsoring bodies, the ABA and the AICPA. The implementation of the Proposed Amendments for the current year would likely result in a chaotic audit season and possibly delay many annual report filings by public companies. Accordingly, we encourage the FASB to study the Proposed Amendments and their implications over a longer period of time and to defer any implementation until after the close of the current calendar year (i.e., the proposal should not be effective, if at all, until those steps have been completed and, in any event, not before 2010).

We appreciate the opportunity to present our comments regarding the Proposed Amendments.

Very truly yours,

  
Michael A. Bloom  
General Counsel

  
Howard L. Meyers  
Chair, Audit Response Committee

cc: Linda L. Griggs, Esq.