June 20, 2008

Proposed Amendment to FASB Statement No. 5 Raises Significant Concerns

On June 5, 2008, the Financial Accounting Standards Board ("FASB") issued an "exposure draft" of a proposed new statement that would replace the disclosure requirements in FASB Statement No. 5, *Accounting for Contingencies*. The proposed statement would also apply to loss contingencies recognized in a business combination accounted for under FASB Statement No. 141 (revised 2007), *Business Combinations.* If adopted, the proposed statement, which would be effective for annual financial statements issued for fiscal years ending after December 15, 2008, and interim and annual periods thereafter, would require companies to make heightened disclosures regarding pending or threatened litigation that could result in waivers of attorney-client privilege and attorney work product protection.

In its current form, FASB Statement No. 5 provides that a loss contingency arising from pending or threatened litigation should be disclosed in the notes to a company's financial statements provided there is "at least a reasonable possibility that a loss . . . may have been incurred." (The FASB defines reasonable possibility to mean that the chance of an event occurring is "more than remote but less than likely." It defines "remote" to mean that the chance of an event occurring is "slight.") When this standard is met, the nature of the loss contingency and the amount or range of potential loss (if determinable) must be disclosed in the notes to the financial statements.

The proposed amendment to FASB Statement No. 5 is motivated by the concern that the "reasonable possibility" standard has not resulted in adequate disclosure of loss contingencies to users of financial statements. The proposed amendment would require companies to disclose substantially more information about their litigation loss contingencies. With respect to pending or threatened claims, the general rule would be that a company must disclose *all* loss contingencies *unless* it has determined that the likelihood of a loss is "remote." Even where the likelihood of a loss is deemed remote, the company would still be required to disclose the contingency if it is "expected to be resolved in the near term" (*i.e.*, within one year from the date of the financial statements) and could have a "severe impact" (*i.e.*, a "significant financially disruptive effect") on the company's financial position, cash flows, or results of operations.

If the disclosure standard is met, a company would be required to include both quantitative and qualitative information about the contingency in the notes to its financial statements. The quantitative information required would be the "amount of the claim or assessment" against the company or, "if there is no claim or assessment amount, the entity's best estimate of the maximum exposure to loss." (If the company believes that the amount of either the claim or the maximum exposure is not representative of its actual exposure, the company would be permitted to disclose its "best estimate of the possible loss or range of loss.") The qualitative information required would include, among other matters, "a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome," "a qualitative assessment of the most likely outcome," and the "significant assumptions" made in estimating the amounts disclosed and assessing the most likely outcome. In addition, the company would be required to disclose a qualitative and quantitative description of the terms of relevant insurance or indemnification arrangements that offset any of the possible loss.

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The proposed amendment raises significant concerns. Since there are relatively few cases in which the likelihood of loss is "remote," disclosure of litigation contingencies could become the rule rather than the exception. Where counsel is unable to conclude that the likelihood of a loss is "remote" — or where counsel can conclude that the likelihood is "remote" but there would be a "near term" "severe impact" if that assessment proved incorrect — companies would have to disclose the contingency, the "best estimate of the maximum exposure," a "qualitative assessment of the most likely outcome" and the "significant assumptions" underlying same. All of this information could be argued to be admissible in evidence against the company in the very litigations that are the subject of the disclosure. Furthermore, disclosing this information could result in judicial findings of waiver of attorney-client privilege and attorney work product immunity that would otherwise protect such assessments from discovery or from use against the company in litigation. And since litigation assessments are inherently uncertain, the proposed amendment itself threatens to become a source of securities litigation when a company's estimates of "maximum exposure to loss" or assessments of "most likely outcome" prove to be inaccurate.

The FASB recognizes that the required disclosures could be "prejudicial to an entity's position" in the litigation. It would therefore create an exemption permitting a company to "aggregate the disclosures required . . . at a level higher than by the nature of the contingency such that the disclosure of the information is not prejudicial." In other words, if a company has a group of litigation contingencies that are subject to the rule's disclosure requirement, the proposal would allow the company to aggregate the disclosures in such a way that, in the FASB's view, the "information could not be linked to its specific case." But the proposal does not explain how this is supposed to work: even if a company is permitted to disclose its "qualitative assessment of the most likely outcome" and the "significant assumptions" underlying that assessment for its cases as a group, depending on the nature of the litigation, such disclosure may nonetheless permit the company's litigation adversaries to link the disclosure to a particular case or subset of cases.

The FASB attempts to address this concern by creating a second step to its prejudice exemption: in those "rare instances" in which the disclosure of information, when aggregated "at a level higher than by the nature of the contingency," would be prejudicial, the company may forgo disclosing the prejudicial information. In such circumstances, the company would still be required to provide the amount of the claim (or if there is no claim amount, an estimate of the company's maximum exposure to loss), and describe the loss contingency and the factors that are likely to affect the ultimate outcome and their potential effect on the outcome, but the company would not have to disclose its qualitative assessment of the most likely outcome. The FASB proposal makes clear, however, that this exception is not intended to swallow the rule, and could be invoked only in "rare" circumstances.

The FASB has set a deadline of August 8, 2008 for interested parties to submit comments on the proposal. Comments may be sent by e-mail to director@fasb.org, File Reference No. 1025-300. We have been advised that the American Bar Association, including the ABA Attorney-Client Privilege Task Force and the Business Law Section's Law and Accounting Committee, are focusing on the significant issues presented by the proposed amendment.

Eric M. Roth