



The increasing focus on the disclosure of information related to a company's litigation exposure was the topic of a recent discussion led by NACD Directorship. Steve Stanton, a managing director in the Disputes and Investigations Practice of Navigant, and Mike McConnell, a partner in the Securities Litigation and SEC Enforcement Practice at Jones Day, provide their perspectives on what directors should be alert to.

Pay Close Attention to Financial Reporting About Litigation

Why has there been so much more attention on disclosing litigation in financial reports?

Steve Stanton: Both FASB and the SEC have stated publicly that the existing rules do not provide sufficient information to assess the likelihood, timing and magnitude of potential losses. In public speeches the SEC staff stated that they may question lack of historical disclosure of the existence or amount of contingencies when settlements are disclosed in future periods. The SEC staff has noted they are concerned that for reasonably possible loss contingencies—which require disclosure of possible ranges of loss, if reasonably estimable—some companies may be too readily taking the position that a reasonable estimate of the loss cannot be made in order to avoid disclosing that information.

Additionally, this heightened focus by the SEC will likely lead to increased scrutiny by external auditors and users of financial statements. Directors should also anticipate that plaintiff counsel will be reading their disclosures carefully.

What are the issues GCs and directors should be alert to?

Mike McConnell: Companies face a balancing act in drafting loss contingency disclosures. On one hand, they need to comply with accounting rules and SEC reporting requirements, and provide full and fair disclosure for investors. However, estimating the likelihood of litigation losses is often a subjective and predictive affair, and doing so with precision can be difficult or impossible, especially in the early stages of litigation. Negative consequences can flow not only from understating the likelihood of a loss, but also from over or underestimating a loss. Given the estimate is inherently subjective and imprecise, the inclusion of an estimate or a range of loss may unintentionally suggest a level of reliability that could be construed to be mis-

leading. Companies should also be wary of disclosing confidential information, including strategy or assessments about litigation, to outside auditors or in public filings. Public filings are, of course, available to opposing parties, so the company's position in ongoing litigation can be harmed if legal strategy is revealed and settlement negotiations can be affected by disclosure of an estimated loss amount.

Auditors are considered outside parties, so companies should also be mindful of the dangers of arguably waiving attorney-client privilege or work product protections. Furthermore, company counsel should be familiar with the "treaty" between auditors and attorneys from the 1975 American Bar Association "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," which discusses the protection of attorney client privilege and largely sets the structure for dialogue between auditors and lawyers.

What roles should GCs and directors have in disclosure of loss contingencies?

Stanton: Directors should be sure they are well informed about material litigation and other contingencies and understand the process their companies use to determine the accounting and disclosures for litigation and other loss contingencies.

McConnell: We would suggest the following:

- Monitor whether the company has effective processes and controls for identifying and evaluating loss contingencies;
- Make inquiries of management, in-house counsel, outside counsel and external auditors about potentially material loss contingencies. For particularly significant matters, directors should consider having status reports at each board meeting;
- Focus closely on these disclosures when reading drafts of public filings, especially on disclosures of *reasonably possible* loss contingencies where contingent loss amounts are not *reasonably estimable* and thus not disclosed; and,
- Be sure you are satisfied that the company is striking the right balance between complying with the accounting rules and the desire to provide full and transparent information to the investing public while not jeopardizing attorney-client privilege or damaging the company's competitive or litigation position.

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