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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**19 April 2007, London**
Project:	**Liabilities - amendments to IAS 37**
Subject:	**GC100 presentation (IASB Agenda paper 8A)**

GC100

Amendments to IAS 37

Materials for 19 April 2007 IASB Legal Proceedings Session

(IASB agenda paper 8A)

30 March 2007

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GC100: who we are

The General Counsel 100 Group (GC100) is a group for the general counsel and senior legal officers of the FTSE 100 companies. Part of its role is to provide input on key areas of legislative and policy reform common to UK listed companies. The views expressed in this paper do not necessarily reflect those of all individual members or their employing companies.

Executive summary

- In legal terms, if an entity has reasonably formed the conclusion at that time that no liability exists or is likely to be found to exist, it should not have to accept that an amount is recognised. Quantum and measurement derive from the existence of a liability.
- The fact of the bringing of a claim cannot be determinative of itself as to whether a “liability” (in the Board’s terms) exists. We do not believe that the bringing of a claim gives rise to a new “stand ready” liability for an entity.
- Requiring premature valuation disclosure would greatly weaken a company's ability to manage litigation risk to the prejudice of the company and its shareholders because opposing litigants would consider that information to set the "floor" for any settlement and because such disclosure risks effecting a waiver of privileges that otherwise would apply to litigation risk assessments.
- We believe that the Board will need to retain a “more likely than not” condition in relation to recognition of a liability because of the complex analysis required in conditions of legal uncertainty. There are differences between these types of liability and others such as financial guarantees, share appreciation rights and so on.
- In many situations, legal uncertainty is more indicative of business risk rather than specific obligations.
- Our comments refer to “litigation”, but this comprises civil and criminal actions, arbitration, regulatory, governmental and judicial enquiries and investigations and similar matters.

Introduction

- The GC100 has previously commented on the proposed changes to IAS 37. We do not seek to reiterate all of those comments here.

- As requested by the IASB, this paper and the related presentations seek to assist the Board in understanding how commercial legal teams approach the uncertainties often associated with legal proceedings or similar circumstances such as regulatory investigations (referred to throughout this paper as “litigation”, for ease).

- We have also, after seeking to address the Board’s specific queries, sought to set out certain further considerations we believe may be relevant to the Board’s consideration as regards the inclusion of litigation within the scope of the amendments to IAS 37.

- To assist in illustrating these points we have also included a small number of real cases: we hope that they will demonstrate some of the issues which can arise in practice.

Preliminary comments

- **Board Approach**

  We welcome the Board's recognition that the proposed changes to IAS 37 give rise to complex issues in relation to litigation, which are not the same as those arising in relation to – for example – a guarantee exposure with an uncertainty as to whether default will occur and the guarantee be called.

- **Existence of a liability**

  We believe that the question of whether or not a liability exists in respect of litigation is frequently complex.

  It is unclear how, in many cases, the analysis required by the Board can practically be applied. We also believe that in many cases there is not a distinction which can easily or logically be drawn between general business risk on the one hand and risk in respect of a liability on the other.

Preliminary comments (cont'd)

- **Recognition and Measurement**

  The Board believes that the relevant approach to the accounting treatment of liabilities should be to regard the issue, where a liability exists, as a question of measurement. However, we remain concerned that in relation to many litigation claims, (1) it is impossible to judge whether an obligation exists that should be recognised, and (2) even when the obligation is established, measurement is simply not possible.

  The Board gives examples where measurement may be possible, but those examples do not reflect the uncertainty that exists in relation to many litigation claims.

  We are also concerned that the existence of a liability and its measurement are in many litigation cases not capable of division as issues in the way the Board envisages.

Preliminary comments (cont'd)

- **Recognition and Measurement**

  In litigation, the question of whether a liability exists is frequently entirely different from the same situation where a financial guarantee exists. If a guarantee obligation exists, a credit/default risk assessment can be made.

  In assessing whether a litigation liability exists, one needs to assess whether (a) any duty or obligation existed, (b) whether a default or contingency occurred giving rise to scope for a financial liability, but also (c) whether the loss claimed against the entity flows from and is reasonably likely to be in respect of the default or contingency referred to at (b). One cannot say an obligation exists, so therefore a liability exists. That is nonsensical to lawyers and companies involved in disputes. The obligation is only relevant if it relates to a matter for which the claimant is entitled to payment.

  It is these uncertainties of facts, duties, causation, loss, in addition to uncertainty as to the law itself on given facts, that typically give rise to the more complex uncertainties arising in litigation.

Preliminary comments (cont'd)

- **Behavioural change**

  The proposals would lead to material behavioural change by parties to litigation. Claims are frequently brought for tactical or speculative purposes. The disclosure that the Board has proposed would be viewed by opposing litigants as settling a "floor" for any possible resolution of their claims—irrespective of the merits of those claims.

  As a result, we fear that the result of the new accounting (if it could be applied in practice) would be larger claims, larger settlements by those subject to claims, and a general improvement in the position of claimants, irrespective of the underlying merits of the relevant claim.

  – Large claims are used as a tactical tool to exert undue pressure on entities to settle in the knowledge that the uncertainty created (rightly or not) can hamper the business of the entity. There will be a greater incentive to increase claims as these will affect the measurement of any recognised liability
  – Claimants will not settle for less than the sum recognised in the accounts
  – Claims will be made at times which disrupt financial reporting obligations
  – Previously recognised amounts may be treated as "sunk" by shareholders, so higher settlements may result as cases are more likely to be judged not worth defending

  The overall result will be significant harm to companies in terms of real costs and thus damage to shareholder value.

Preliminary comments (cont'd)

- **Privilege Issues**

- In addition, the disclosure and the materials and analysis underpinning it likely would be discoverable in pending (or even future) litigation. Currently, these types of materials generally are protected by the attorney-client privilege and other doctrines (e.g., the work-product doctrine). However, under the proposed approach, these materials would provide the basis for a public disclosure and, therefore, likely would not be covered ay any privilege or immunity. Further, statements about (or supporting) a company's view of its litigation risks (irrespective of the degree of accuracy of such statements) could be admissible into evidence in the case as admissions -- which would further weaken the company's litigation position.

- Moreover, these considerations would strongly incentivise a company to report the lowest possible valuation and to support that valuation with cryptic, incomplete or otherwise unreliable assessments of the company's litigation risk. The disclosures based on such materials would be inherently less reliable, which would undermine any benefit sought to be secured from the Board's proposal.

Preliminary comments (cont'd)

- **Consistency issues**

  We understand the Board's desire to achieve greater consistency of approach as between different Standards. We continue to believe that the changes still contemplated by the Board, if applied to litigation, will create new inconsistencies and may not recognise the differences innate to certain litigation claims, which justify their different treatment in certain circumstances.

  – Assets and liabilities recognised on acquisition are dealt with differently from those already held, e.g. internally-generated intangible assets.
  – In business combinations, contingent liabilities that are fair valued on acquisition may still continue only to be disclosed in the acquired business. The difference is that an acquirer is making an adjustment to the purchase price for uncertainty about business risk, not a decision about whether an obligation exists.
  – The difficulty of assessing the value of a litigation-related contingent liability may actually prevent a takeover occurring, i.e. inability to value will often stop a transaction in practice

IASB questions: Part A

Question 1

- **Q. What factors do legal teams consider in determining whether an entity has a case to answer and therefore a present obligation exists?**
- **A.** In simple terms, legal teams consider all relevant factors. There is not a checklist or standard approach and the circumstances and relevant factors vary materially from case to case and jurisdiction to jurisdiction.

  A fundamental question will be whether the entity has duties or obligations to the claimant. This is often a complex, multi-factor analysis with dozens or even hundreds of co-dependant elements.

  Particularly at the early stage of a matter, it is usually not practicable for a legal team to examine what may be thousands of documents, which could take months if not longer, in order to assess whether a present obligation exists.

IASB questions: Part A (cont'd)

- Issues that may be relevant to this analysis include:
  - What are the facts? The scope of liability depends on the specific facts. A potential liability which relates only to different facts (in respect of which there is no loss or obligation) is not a liability at least as a matter of law.
  - What is the relevant governing law or laws and what is the court or tribunal with jurisdiction?
  - Are there limitation defences available which mean no obligation survives?
  - How clear is the law in relation to these facts, to the extent identifiable? Doubts as to the law on precise facts frequently exist. Even if case law suggests the law will operate in a particular way, what are the differentiations between the circumstances of those cases and the current case? It is frequently the position that there is no decided case law exactly on point or that the law is not clear
  - What is the possibility of a statutory provision being interpreted or a previous case being over-ruled or distinguished differently, perhaps by a higher court?

IASB questions: Part A (cont'd)

Question 2

Q: When legal advice indicates that a present obligation exists, what factors might influence an entity's decision to pursue a matter through the courts or negotiate a settlement?

A: The question assumes an approach that can occur with certain claims, particularly where the existence of legal obligations relating to accepted facts is accepted or clear. However, in vast numbers of cases, the approach implicit in the question does not exist as:

- It is unclear whether an obligation exists, or
- It is unclear whether the facts of the case give rise to loss flowing from a default in the obligation; or
- Other uncertainties exist which means that no liability arises

The factors considered in assessing the approach an entity take to dealing with a claim will evolve during the course of a claim, but include the same wide range of factors – and other relevant ones – listed at the answer to question 1. Additional factors include:

IASB questions: Part A (cont'd)

- What are the economic circumstances and business pressures for the entity (irrespective of whether a liability may exist)? What is the value of the claim compared to the management time and expense of legal advice? What are the ramifications of settling a claim, whether or not meritorious? Does it create an unhelpful and unreasonable precedent, or does it facilitate the entity pursuing other opportunities if the claim has been removed?
- How much information is available to indicate the strengths and weaknesses of a claim? This frequently emerges over a long period during the course of litigation, so views from legal teams on prospects of success or failure of a claim are either not given at all, or at least not until a late stage, or are expressed in terms only of evidence so far, recognising that material uncertainty exists.
- Whether any acceptance of liability has been made by the entity, or any indicators exist of such an acceptance
- The likelihood of the other party being willing to settle and if so, at what level. Is it possible to assess the motivations and drivers of the claimants to gain some insight into whether they might settle and on what terms?
- The quality of the evidence (if it can be assessed), its likely reception in court, the court context (jury or not) and even who the judge will be.

IASB questions: Part A (cont'd)

- The experience of the relevant legal team will be relevant, but it is noteworthy that experience of multiple claims of an apparently similar nature (e.g. employment cases, where each is dependent on facts) may give the legal team a basis for guessing how these facts will turn out (e.g. out of 70 prior claims, 50 turned out to involve liability). However, that has nothing to do with the – as yet unknown – facts of the employment claim, but is only an assessment based on other claims. Recognising a liability in those circumstances is therefore a form of general provision.

These are a very limited illustration of possible factors of relevance. The legal team will often reach the view that it is unclear whether or not an obligation exists, with a resultant potential liability. The legal team will often decide that it has insufficient information to form a view, but that the entity would not pay anything to remove the claim until such time as it has sufficient information to judge whether using its funds to discharge the claim is justifiable. That, in many situations, will only be at a later stage or in some cases only after the trial of the action.

IASB questions: Part A (cont'd)

Question 3

Q: When legal advice indicates that no present obligation exists, what factors might influence an entity's decision to negotiate settlement?

A: Again, the question assumes a simpler set of facts than tends to occur in practice. In reality, advice is not given in the terms suggested: the advice will at most relate to certain facts known or assumed: the assumptions are key. As noted above, even where an entity believes it has no liability in respect of a claim, it may seek to settle a claim for a variety of reasons:

- It may receive a volume of similar claims which it may for business reasons regard as a general business risk and cost (e.g. a supermarket receiving claims for poor quality food), which are better absorbed to maintain good customer relations, provided the settlement offered is limited;
- Its relationship with the claimant and the value of that relationship;
- Its desire to avoid adverse publicity;
- Its desire to avoid legal expense and management time being incurred and/or wasted, particularly in circumstances where some or all of those costs are unlikely to be recoverable;

IASB questions: Part A (cont'd)

Question 3 (cont'd)

- In relation to a relatively substantial claim, the advantages of eliminating any uncertainty that exists as regards the claim, or eliminating the perception of uncertainty that, for example, its shareholders may have.
- The ability of the claimant to pursue or sustain a claim. It is worth noting that different entities will respond very differently to the same set of claims, depending on their appetite for any level of risk or uncertainty.
- The court may direct the parties to negotiate with a view to settlement or may impose mediation.

IASB questions: Part A (cont'd)

Question 4

Q: To what extent are your answers to the questions above influenced by the legal requirements of individual countries? For example, is there a significant difference in the way you evaluate a lawsuit lodged in a jurisdiction with a legal system based on code law, or a jurisdiction which permits class actions?

A: The approach is always influenced by all relevant factors and the nature of the law, the degree of uncertainty of it, the court process and the way in which information becomes available at different stages in different jurisdictions will all be relevant. Enforcement of claims will vary from jurisdiction to jurisdiction.

There is often no clear distinction between general business risk and risk of the existence of liability. Sometimes the law is unclear, either because of an ambiguity, or the absence of clarity as to its application on the particular facts, or the prospect of judges developing the law.

IASB questions: Part A (cont'd)

The dynamics are in theory different in different jurisdictions: under common law systems, judges are bound by precedent, whereas under civil law systems precedent may not bind: in practice, legal uncertainty frequently arises under both systems and the form of that uncertainty is of limited relevance. We do not see a distinction in practice between, on the one hand, the risk of a court on particular facts developing or changing the law (which happens in litigation) and on the other hand, the relevant government passing new legislation to clarify that an obligation exists.

Any company is at risk at any time of third parties bringing claims against it, which may or may not be merited. The extent to which tactical or spurious or honest but misconceived claims are brought varies from jurisdiction to jurisdiction (influenced in some cases by cost rules, ease of class actions and other factors). However, such claims are brought in all jurisdictions. Such claims seem to us, in commercial and legal terms, in many cases, to be very much "general business risks", quite distinct from, say, a financial guarantee with a resultant credit risk.

Finally, in some jurisdictions there are risks of political interference in disputes and in others risks of judicial corruption by a dishonest claimant.

IASB questions: Part B

Question 5

Q: How do legal teams establish the range of possible outcomes associated with a particular lawsuit?

A: Legal teams seek to understand as many facts as are available, to assess the scope of potential liability and other matters identified in relation to the Board's questions regarding existence of liability. Assessment of outcomes is not a distinct exercise from assessment of risk of liability: it is the same exercise, and involves an analysis of the various merits of the claim, legal and factual, as well as contextual issues.

Unlike a financial guarantee, for which measurement involves a credit risk evaluation – a developed and widely used skill – the assessment in litigation turns on multiple factors, potentially running to hundreds or even thousands of elements. There are in some cases precedents which give strong guidance as to the law. If facts are clear, it may be feasible to give a view as to what outcomes are possible and prospects of one or another outcome. However, in larger or more complex cases, this tends to be impossible.

IASB questions: Part B (Cont'd)

Question 6

Q: What information do legal teams provide entities to assist them in estimating the individual most likely outcome within the range of possible outcomes?

A: This depends very much on the particular entity and case and there are no set practices. In general, legal teams assess the claim made, evaluate its merits based on whatever information is at that time available to them, discuss with the entity the factors surrounding the entity's approach to such claims and to the extent practicable, give advice on the merits accordingly. Advice typically identifies areas of uncertainty: advice is frequently not given in writing but as part of an interactive process. In other cases, written (privileged) advice may be provided, with appropriate caveats, by external legal advisers.

The legal team may look at precedent cases, although as already noted these are of limited value because of variation of facts and uncertainty as to whether the courts would always follow a precedent case. However, these are unlikely to be supplied to the entity; they are merely used to inform the legal team judgement.

IASB questions: Part B (Cont'd)

Question 8

Q: What additional information would legal teams need to provide entities to estimate the probability-weighted cash flows required to compile an expected value calculation? Are legal teams willing/able to provide this information?

A: Legal teams will not provide this information. Indeed, legal teams would not admit the concept of probability weighted cash flows as bearing on their advice or forming part of their role. In certain cases, business or financial teams within an entity may feel that they have sufficient experience of the type of claim (particularly with smaller multiple claims) to take a statistical view on probability, perhaps only marginally influenced by legal advice: this is in effect a form of general provision. However, in many cases the issues involved are distinctive, the existence of liability and scope of it turn on facts and judgements unknown. Legal teams will analyse a case on its individual merits, not on a "probability-weighted" basis, which masks inherent uncertainties: those uncertainties do not necessarily reflect the existence of a liability, they simply reflect the level of complexity that may be inherent in certain situations as regards the relations between an entity and a third party.

IASB questions: Part C

Question 9

Q: How could the Board improve its disclosure requirements for ongoing legal proceedings without prejudicing the entity's position, both when an entity concludes that a present obligation exists and when an entity concludes that no present obligation exists?

A: The Board's view is that boilerplate disclosure may in some cases be used too readily. This is not a straightforward issue and the best course would perhaps be for us to discuss with the Board the extent to which more extensive disclosures may be possible in practice, while still protecting the entity's position.

It is important to note that there are some circumstances where an entity may be under a legal obligation not to disclose, e.g. to avoid "tipping off". Similarly, lawyers may be restricted in some jurisdictions in the type and extent of advice they can offer their clients.