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International Accounting Standards Board

INFORMATION FOR OBSERVERS

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Project: **Liabilities - amendments to IAS 37**

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GC100/IASB MEETING ON 19 APRIL 2007

Dispute resolution in England & Wales and the USA

1. To assist the Board, we set out below a brief summary of the procedures which may be involved in the resolution of disputes in England & Wales and the USA. We recognise that the Board is setting standards in an international context and therefore cannot take account of jurisdictional idiosyncrasies, but we believe this broad outline will help in the consideration of the example cases and in our discussion generally. We will of course be happy to explain and elucidate any legal terms (lawyers are just as fond as jargon as accountants!); we have put certain limited explanations in the text as footnotes.

1.1. If disputes cannot be resolved consensually, they will generally proceed to a dispute resolution process. In broad terms this will mean one of litigation, arbitration or a form of Alternative Dispute Resolution

("ADR"), the best known of which is mediation. Litigation and Arbitration produce decisions which are binding on the parties; ADR does not, so that if it fails, parties are still at liberty to proceed to litigation or arbitration.

1.2. We do not here deal with disputes resulting from regulatory investigations, but these can of course result in significant liabilities. Generally statute or regulation will provide for the procedures under which such investigations will proceed and will often include the formation of specific tribunals to adjudicate on them (eg the Competition Appeal Tribunal).

2. In **English High Court litigation**, the basic procedural steps are as follows:

2.1: The Claimant goes through the required Pre-action Protocol procedure – essentially a notification of the claim in a way which encourages the parties to investigate the possibility of a settlement without the need for legal proceedings.

2.2. The Claimant issues and serves a Claim Form (with or without full particulars of the claim), which initiates the legal proceedings proper.

2.3. The Defendant acknowledges service of the Claim Form and states whether or not he intends to defend the claim.

2.4. Assuming the Particulars of Claim have been served by the Claimant, the Defendant then serves his Defence, together with any counterclaim he may have.

2.5. The Claimant may then serve a Reply and, where necessary, a Defence to any Counter-claim.

2.6. A case management conference with the court will take place; issues between the parties should have been identified by this stage and the court will deal with any directions which are required, for example in relation to the disclosure of documents and permission to serve expert evidence.

2.7. Disclosure of documents will take place as between the parties.

2.8. Witness statements and experts' reports will be prepared and exchanged.

2.9. Trial preparation will take place, followed by the trial itself, which will involve witnesses of fact and experts appearing before the court for cross-examination by the parties' legal representatives. The trial will be presided over by a High Court judge, who will deliver a written judgment, usually some months after the end of the trial.

2.10. Any appeals will then take place in the Court of Appeal and (rarely) the House of Lords.

A piece of High Court litigation will often run over a period of 2 or more years, before it gets to trial. Most actions however settle before trial. The basic steps can become significantly more complicated where there are multiple parties and claims dealt with in one proceeding. There may be many different types of applications within the action, for example challenging the jurisdiction of the court, seeking interim injunctions freezing assets and so on. Few actions which proceed to trial in the High Court are straightforward.

Procedures in the United States are similar in basic respects to those set out below, with the notable exceptions that (i) there is rarely a requirement for the parties to explore a pre-filing resolution of the claims, (ii) United States procedures provide for significant opportunities for parties to file motions on a host of substantive and procedural matters prior to (and even during) trial, (iii) pre-trial discovery in United States litigation may be even more extensive than the disclosure procedures in the High Court and include pre-trial testimonial examinations (commonly called "depositions"), and (iv) many claims in the United States are subject to trial before a jury.

3. In **arbitration**, the steps are less formal but often similar to those referred to above. However, arbitrations generally take place pursuant to an agreement between the parties who will select the governing law, the seat of the arbitration and its rules, for example, of the Rules of the International Chamber of Commerce, i.e. the approach to arbitration is more international in nature. The arbitration will usually be presided over by one or more arbitrators who are engaged by and paid for by the parties. Following the arbitration hearing (the equivalent of the trial in the High Court), the arbitrator(s) will deliver an award. Appeals from arbitration awards are generally restricted, but this does vary from jurisdiction to jurisdiction.

4. **ADR**, in particular mediation, is a very flexible procedure. The parties will usually agree the steps in the process with the Mediator who will simply facilitate a settlement between the parties usually by bilateral contact following an initial meeting of the parties and the Mediator together.

Examples of cases

6. The IASB has recognised that lawsuits are particularly problematical, when it comes to assessing whether an entity has a present obligation on the balance sheet date. The first two examples below refer to litigation in England, where we hope to give the Board a fuller flavour of how companies and their legal advisors approach disputes in practice. The information on which we rely is drawn from publicly available sources. We thought it would be better to use actual cases as the basis for our examples rather than purely hypothetical ones, to show that how complex these situations can be: case studies would be too simple or appear contrived in their complexity.

Example 1: the asbestos cases and changing law

7. *The Fairchild case*

7.1. There has been a succession of cases in the English courts relating to liability to employees (or their estates) who have contracted and died from mesothelioma. Most recently the issue has been how the law should deal with the situation, where the harm caused to the employee has been (or could have been) caused by more than one employer. The problem caused by the existence of multiple possible defendants combined with gaps in scientific knowledge about the aetiology of a particular disease was illustrated by the case in 2002/2003 of Fairchild v Glenhaven Funeral Services Limited.

7.2. Asbestos has been used for many years in the construction industry for its valuable properties as a material resistant to heat, acids and alkali. In the Fairchild case, the employees had all worked for a number of employers and at a number of sites where they had been negligently exposed to asbestos fibres. They contracted mesothelioma, which is a disease which may be latent for up to 40 years but then develop fatally over 10 years. However in this case the employees could not identify which employer was responsible – the disease is not a cumulative one (unlike asbestosis), and exposure may cause no harm at all. The Court of Appeal applied the usual test of causation[1] and found that the employees could not prove that the fibres which had caused the disease to develop had been inhaled as a result of any particular employer's breach of duty. As a result the employees' claim failed.

7.3. This appeared to produce an unjust outcome so far as the employees were concerned, with the result that the House of Lords reversed the decision and held that in the special circumstances of this type of case, there should be a relaxation of the normal rule that a claimant must prove

[1] In simple terms, the test for causation is the "but for" test, i.e. that a claimant must establish that, but for the defendant's wrongdoing it would probably have acted in a different way, whereby it would not have suffered the relevant damage.

that but for the defendant's breach of duty he would not have suffered the damage. The injustice to the defendant of adopting this approach, the court said, had to weighed against the injustice to the claimant of insisting on the strict application of the rule of causation. As a result the employees were able successfully to recover the entirety of their damages against any of the employers in question.

8. *The Barker case*

8.1. In 2006 a similar set of facts came again to the House of Lords in the case of Barker v Corus. In this case an important issue was whether the damages due to the employee should be apportioned as between the negligent employers – and indeed the employee who had been guilty of contributory negligence - or whether (as in this case where some of the former employees were insolvent) those employers who were still traceable and solvent should be liable to compensate the employee for the entire harm caused.

8.2. Following Fairchild, the general view of the law in the case of mesothelioma was that the last proposition was correct, ie any single employer could be liable for the entire harm. The House of Lords in Barker however decided that this was not the law and that each defendant should only be liable in proportion to the share of the total exposure to a risk of the disease for which it was responsible – in other words a return more or less to what had been thought to be the position before Fairchild.

9. *The Compensation Act 2006*: the decision in Barker produced a public outcry to which the British Government was quick to react. Within a short time a new clause was inserted into what became the Compensation Act 2006, the effect of which was to reverse the apportionment rule established for mesothelioma cases in Barker.

10. *Comments*:

10.1. Now consider the position of an in-house counsel at a construction company over the last few years, who knows that his company has employed workers in the past who had been exposed to asbestos as part of their jobs. So far as mesothelioma is concerned he would not know (nor could he reliably estimate), whether any of those workers would contract the disease; he would only know, once a worker had actually exhibited the disease's symptoms - notwithstanding exposure over a protracted period, it is entirely possible for a worker not to contract the disease at all; contrariwise, a worker could contract the disease on his first exposure to asbestos fibres. Under the proposed revised IAS 37, would there be a liability on the part of the company at this stage or not? If so, how would the company go about measuring it?

10.2. Once a worker started to exhibit symptoms of the disease, the in-house counsel's assessment of the company's responsibility (and therefore liability) would have been different between 2002 and 2006, depending upon whether he made that assessment after the Fairchild decision in the Court of Appeal (no liability) or the House of Lords (liability) or after the Barker decision in the House of Lords (no liability) or after the coming into law of the Compensation Act 2006 (liability). How should this (or similar) uncertainty in the law affect the assessment of liability?

10.3. We think these two English cases demonstrate how changes in the law over a relatively short period of time can make it virtually impossible to judge whether or not a defendant had a liability at any given stage (eg a balance sheet date). The law effectively changed not once but three times over three years, as the House of Lords gave its two rulings and the Government passed legislation, all affecting the same issue.

Example 2: commercial fraud

The Freightliner case

11. This is a commercial case which involved multi-party litigation both in England and the USA and a series of different claims in contract, tort[2] and (in the USA) breach of statute. It has given rise to considerable comment and interest in the English legal profession, because it has dealt with some difficult and topical areas of law.

12. *Parties*: although many companies were involved, the principal parties in the dispute were:

MAN Nutzfahrzeuge AG (Germany)

Freightliner Limited (UK)

ERF Limited (UK)

Freightliner LLC (USA)

Ernst & Young (UK and Canada)

13. *Proceedings:* the main proceedings were brought in the High Court in London by MAN against Freightliner Limited and were commenced in 2002. Freightliner Limited brought a contribution claim[3] against Ernst & Young. The judgment was delivered on 28 October 2005 in favour of MAN on the claim for fraud and for Ernst & Young on the contribution claim. An appeal against part of that judgment (the contribution claim) is currently before the Court of Appeal. A separate trial of the issues

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[2] The dictionary definition of "tort" is a wrongful act or an infringement of a right (other than under contract) leading to legal liability.

[3] Known as a Part 20 claim in English law which includes, inter alia, a claim by a defendant against any person (whether or not already a party) for contribution or indemnity or some other remedy.

relating to the precise quantum of damages is yet to take place. There are also parallel proceedings in the courts of Oregon, USA, in which MAN seeks to ensure that its damages in the High Court action can be recovered from Freightliner Limited's parent, Freightliner LLC and others.

14. *Facts*: these were complicated and only established after the High Court Judge made findings of fact in his judgment after hearing the evidence at trial. In essence, the Financial Controller of ERF, Mr. Ellis, made a series of fraudulent misrepresentations about ERF's financial position prior to, during and after the sale in 2000 of ERF by its parent company, Western Star (subsequently merged with Freightliner Limited which inherited its liabilities). MAN discovered the fraud in 2001 and notified Freightliner of the possibility of a claim later that year.

15. *The claims*: MAN sought to hold Freightliner liable for Ellis's fraud, on the basis that Western Star had held Ellis out as its agent, something that Western Star strongly disputed both as a matter of fact and in law. MAN's claim, which included very substantial sums it expended after the fraud came to light, was in the region of £400 million. The amount of the claim was also strongly challenged by Freightliner on various legal bases (causation, mitigation and so on). Freightliner itself claimed that, if the court held it to be liable to MAN, Ernst & Young's alleged negligence in auditing ERF should mean that it should pay a proportion of the any damages awarded against Freightliner.

16. *The issues in the High Court*: the requirement to establish facts which were disputed and the law on the multiple claims before the court meant that there was a high degree of uncertainty about the likely outcome of the proceedings both in relation to Freightliner's liability but also in relation to the liability of Ernst &Young. By the time of trial, the judge was faced with having to rule on a series of complex issues, which included the following:

16.1. Could Freightliner, which knew nothing of Ellis's fraud, be vicariously liable for Ellis's fraudulent misrepresentations without a transfer of control of his conduct from ERF to Western Star under the Mersey Docks principle?

16.2. Did Western Star as a matter of fact put Ellis forward to speak about the financial position of ERF, in such a way as to hold him out as having authority to speak about such matters on its behalf?

16.3. Were Ellis's fraudulent misrepresentations sufficiently closely connected to the task which Western Star authorised Ellis to do, such that it was fair and just to hold Western Star (and thus Freightliner) vicariously liable for them?

16.4. Were representations by Western Star in the SPA with MAN made fraudulently?

16.5. Was MAN entitled to recover damages for all its losses under a specific indemnity contained in the SPA which appeared to be limited to tax?

16.6. Was Ellis acting for ERF or for Western Star during the due diligence process?

16.7. Did Ellis's presence in ERF amount to a "latent defect" of a kind which makes it appropriate to regard losses flowing from the continuation of his conduct in the same course of dishonesty as losses flowing from the transaction?

16.8. Was there a duty owed by Ernst & Young to Western Star, the parent of its audit client, in circumstances where Ernst & Young were aware of the proposed sale of ERF by Western Star and knew that a copy of ERF's audited accounts, which it provided to Western Star, would also be provided to MAN in the course of negotiations for the sale of ERF to MAN?

16.9. Did disclaimers of liability in Ernst & Young's hold harmless letters extend to liability which could otherwise arise from use made of their report?

16.10. Was the limitation of liability clause in Ernst & Young/s engagement letter with ERF effective to limit liability to Western Star?

16.11. Did the doctrine of reflective loss[4] apply?

16.12. What was the correct test of causation for losses, where there have been fraudulent misrepresentations leading to a transaction such as this?

16.13. Specifically, were losses caused by fraudulent representations made to MAN by Ellis <u>after</u> the sale of ERF sufficiently causally connected with the original fraud, such that Freightliner should be liable for them?

16.14. Should damages simply reflect the difference between the price paid by MAN for ERF and a valuation of ERF at the date of purchase: was this at least the appropriate starting point for the assessment of MAN's loss?

16.15. Was compound interest awardable in respect of losses which represent money obtained as a result of a fraud?

16.16. To what extent in the circumstances should MAN have mitigated its loss?

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4 Reflective loss is loss that is merely a reflection of the loss suffered by the relevant company, (e.g. a decrease in the value of shareholders shares) and other losses suffered by a shareholder as a direct result of the loss suffered by the company (e.g. loss of dividends).

17. *The issues in the US proceedings:* we understand from publicly available information it was argued that certain inter-company transactions as between Freightliner Limited and Freightliner LLC (and possibly other group companies) had the effect of transferring assets out of Freightliner Limited either for inadequate consideration or in some way designed to defeat MAN as a potential creditor, with the result that under Oregon law Freightliner LLC should be held responsible for any unsatisfied liability which Freightliner Limited may have to MAN. In December 2006 the Oregon State Court ruled in favour of MAN.

18. *Comments*:

18.1. This case, which has been fiercely fought over a number of years, was essentially about which of three parties innocent of the fraud should bear the losses ultimately caused by Ellis's misrepresentations – MAN the purchaser of ERF, Western Star/Freightliner the vendor or Ernst & Young as ERF's auditor. As is clear from the High Court judgment, there were a considerable number of disputed and inter-related facts and issues of law as between all of the parties and a very large sum of damages at stake.

18.2. In-house counsel for Freightliner and E&Y (and indeed the external lawyers retained) would have faced formidable problems prior to trial in advising on both the existence of a liability and how that liability should be measured. Before the discovery of the (concealed) fraud in 2001 but after the transaction in 2000, Freightliner would simply have known that it had given various representations and warranties to MAN in the Sale & Purchase Agreement. The limitation period for bringing claims in relation to these (save as regards tax) had however expired, before it was informed of the possibility of a claim by MAN.

18.3. After notification of the claim, Freightliner would not have known the full facts, nor did it accept that it was responsible in law for such fraudulent misrepresentations as may have been made by the employee of ERF which MAN had acquired. Furthermore, there were serious issues raised about whether the losses claimed by MAN had been caused by the misrepresentations for which it argued Freightliner was liable.

18.4. Ernst & Young (Canada and UK) was faced with claims by Freightliner, that it had negligently performed its audit of ERF and that it should accordingly bear a proportion of any damages which might be awarded against Freightliner by the court. The question of liability revolved around a difficult area of liability for negligent misstatement relied upon by a third party (ie not by Ernst & Young's audit client, ERF). As it happened, the judge held that Ernst & Young had been negligent but that it owed no duty of care to Freightliner. If it had, the judge would have had to decide what proportion of the damages awarded against

Freightliner Ernst & Young should be liable for. There is no science to this, since it is in the discretion of the court and that discretion will be exercised on the basis of the evidence which the judge has heard at trial.

18.5. In the Freightliner case, many of the issues of law were very complex and some have been characterised by commentators as ones which will ultimately need to go to the House of Lords for determination. Each of the parties involved would have had enormous difficulty in objectively deciding where the liability lay - at least before the High Court judgment had been handed down. Even then, there remain issues about the quantum of the damages which are yet to be resolved and the appeal currently in the Court of Appeal may result on some parts of the original judgment being overturned. There will no doubt be similar issues in the US proceedings.

Example 3: US securities class actions

19.1. The difficulties of advising on the existence and extent of liability are at least as pronounced in United States litigation as they are in litigation in England & Wales (and elsewhere), particularly in the types of complex disputes in which substantial business organizations often are involved. Those difficulties arise for various reasons, including the difficulties of determining the relevant facts and of applying the relevant legal elements to those facts, as well as the uncertainties that arise from constant-evolution of legal doctrine. These legal uncertainties are compounded in cases involving federal law, which applies to many of the major claims (such as many securities, antitrust, environmental and employment actions) because the law might be interpreted differently (and, thus, could evolve differently) in the many federal courts around the county.

19.2 By way of background: each of the 50 United States and the District of Columbia has a full system of state courts, including trial-level courts and one or more appellate level courts. In addition, each state (and the District of Columbia) hosts one or more federal district (trial-level) courts, which can resolve federal law and certain state law claims and, in the process, are called upon to interpret and apply relevant law. Appeals from the decisions of those federal district courts are heard by one of the 12 regional circuit courts of appeal. Appeals from the decisions of those circuit courts may be heard, as a matter of discretion (rarely as a matter of right), by the United States Supreme Court. At each step of the process, then, the courts—both state and federal—apply and interpret relevant law, frequently in ways and at times that are diverse and even inconsistent.

19.3. The difficulties of prediction inherent in, and occasioned by, the litigation system and process in the United States can be illustrated by

reference to a federal securities law claim, to which companies (both domestic and foreign) frequently are subject in the United States courts.

19.4. The circumstances that could give rise to a federal securities law claim are myriad: such claims, irrespective of their merits, can follow closely on the heels of essentially any corporate development, including (just to specify several) announcement of unexpected financial results or a change in credit rating or business plans, or disclosure of an acquisition initiative or corporate reorganization,

19.5. In-house counsel attempting to understand the parameters of the claim would first seek to learn the jurisdiction in which it was filed (because of the diversity of doctrinal development among the various jurisdictions, as discussed above), the nature of the claim (including whether it is filed on behalf of a class of plaintiffs or by one or only several claimants) and whether the claim is one of "primary" liability seeking recompense from the entity that authored the allegedly false or misleading disclosure or is premised on assertions of "secondary" liability against others (such as commercial bankers, investment bankers or auditors) who supposedly aided and abetted securities law violations of others. The contours of the law regarding secondary liability claims are particularly diverse from jurisdiction to jurisdiction, as is manifest in the recent decisions in the Enron litigation pending in federal court in Texas.

19.6. Inevitably, lawyers working on the defence of a securities law claim must turn to the virtually endless task of compiling and assessing the relevant facts. This process continues throughout the entirety of the litigation, from receipt of the claim until (and, in some cases, even during and after) trial and is an essentially all-encompassing endeavour involving review and analysis of millions of pages of documents (in paper and electronic forms), interviews and discussions with potential witnesses (both from within the company and elsewhere) and expert witnesses and consultants, and the conduct and analysis of pre-trial depositions and other evidence provided from parties and countless non-parties.

19.7. The principal task of the factual assessment is to aid in determining whether those facts provide the basis for satisfying the legal elements of a claim. In the case of a federal securities fraud claim, those elements include primarily determinations of: (i) whether there was a false or misleading statement; (ii) if so, whether that statement was materially false or misleading; (iii) if so, whether it was intentionally (or, in various jurisdictions, recklessly) false or misleading; (iv) if so, whether the defendant had a legal duty to avoid making such a statement; (v) if so, whether the plaintiff or group of plaintiffs relied on that statement in deciding whether to buy or sell securities; (vi) if so, whether that reliance

was reasonable in the circumstances; (vii) if so, whether the plaintiff or group of plaintiffs suffered legal injury; (viii) if so, whether any portion of that injury was legally "caused" by the allegedly false or misleading statement; (ix) if so, what portion of that injury is actually attributable to the defendant's misstatement or omission (as opposed, for example, to general market movements or changes in the company's stock price resulting from other causes); and (x) if so, whether any other applicable circumstances require or preclude a determination that the defendant should be held responsible for the alleged loss.

19.8. These determinations are obviously highly-fact dependent and many require substantial study and analysis. For example, the determination of whether a plaintiff reasonably relied on a statement by the defendant would depend on various facts, many of which remain solely in that plaintiffs' possession and could be developed only during the course of the entirety of the litigation. Similarly, the determination of whether and, if so, to what extent, a statement caused a financial loss to an investor requires, at a minimum, months of work by trained economists and other experts employing sophisticated modelling and other analytical techniques.

19.9: In addition, changes in legal doctrine, such as relatively recent rulings by the United States Supreme Court on matters of secondary liability and causation, can have dispositive impacts on the case analysis and the litigation, itself.

19.10. Decisions by the presiding court during the course of the litigation regarding numerous issues, including the viability of certain claims or theories, the proper scope of pre-trial discovery and acceptability of expert witnesses and methodologies, also have an indispensable impact on any meaningful assessment of litigation risk in a federal securities law claim. Similarly, such an analysis must take into consideration of the nature and quality of the evidence, both documentary and testimonial, and various other intangible considerations, such as the legal, local and general context in which the claim would be heard.

19.11. Principally for these reasons, parties that are subject to federal securities law claims find it impossible to render even minimally useful predictions as to the outcome of the case until full development of the facts and application of the relevant, current legal doctrine to those facts—a process that is by definition, interative and incessant and that generally cannot occur until at least the close of the pre-trial discovery period or even later.