Disclosure of Environmental Liabilities in SEC Filings 2004

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I. INTRODUCTION

A. Background

Various factors have led to heightened concern over disclosure of and accounting for environmental matters by public companies:

- Change in the Legal and Political Atmosphere

The Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”) and the corporate accounting scandals that led to the passage of that Act have altered the face of securities law disclosure. While the scandals that resulted in the Act’s passage did not themselves involve fraudulent environmental accounting, regulators are now requiring increased corporate transparency and accountability with respect to all securities disclosure. In particular, the Sarbanes-Oxley Act requires principal executive and financial officers to certify as to the accuracy of the disclosure contained in the periodic filings of their companies. As a result, reporting companies must take care in preparing and reviewing their environmental disclosure and be prepared to justify the steps they have taken, and the resulting disclosure, to the Securities and Exchange Commission (the “SEC”) and to their shareholders.

- Various Private and Governmental Entities Have Questioned or are Reviewing the Quality of Existing Environmental Disclosure

Price Waterhouse (now PricewaterhouseCoopers), an accounting firm, and the United States Environmental Protection Agency (the “EPA”) released studies in the 1990s concluding that companies have been under-reporting their environmental liabilities. PriceWaterhouseCoopers’s survey of SEC registrants in 1992 indicated that 62% of the survey’s respondents failed to properly accrue for their environmental liabilities. Similarly, the EPA’s study found that companies in 1996 and 1997 disclosed accurately only 16% of environmental governmental proceedings involving penalties in excess of $100,000. Based on these findings, the EPA released an enforcement alert in October 2001 stating its intention to monitor the disclosure of companies party to its enforcement actions.

ASTM International, a leading voluntary standards development organization, issued detailed standards in 2001 which provide a series of options for drafting environmental liability disclosures accompanying financial statements and provide guidance as to how to estimate and accrue for environmental liabilities. Various not-for-profit groups representing the investing public petitioned the SEC in September 2002 to promulgate new rules which would incorporate these rigorous standards. These groups believe the lack of uniform standards has led to the under-reporting described above.

The SEC has expressed its concern with the adequacy of environmental disclosure in public filings through rules, releases, bulletins and other statements. These documents have expanded and have clarified the standards the SEC expects companies to meet in their disclosure of environmental matters. The SEC, however,
has not aggressively enforced these rules and releases – it appears the SEC has brought only a handful of environmental disclosure proceedings in the past twenty-five years and only one in the past twenty. The push for increased transparency and accountability, however, has now spurred the SEC and others to examine the accounting and securities disclosure rules to determine whether significant non-compliance problems exist.

The SEC recently reviewed the environmental disclosure contained in periodic reports filed in 2001 by Fortune 500 companies. The results, released in February 2003, indicate that many companies are failing to disclose their environmental reserves in accordance with Staff Accounting Bulletin 92 (“SAB 92”). These results are consistent with the 1992 PricewaterhouseCoopers survey described above.

The Sarbanes-Oxley Act requires the SEC to review the periodic reports of reporting companies on a “regular and systematic basis”, and in any event, at least once every three years. As a result, all companies, and particularly Fortune 500 companies, must review, and be prepared to defend, their environmental reserves and the narrative disclosure supporting them (both in the notes to the financial statements and as part of the Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”)).

Finally, on July 15, 2004 the U.S. Government Accountability Office (the “GAO”) submitted a Report to Congressional Requesters, U.S. Senators Jeffords, Corzine and Lieberman, entitled Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information (the “2004 GAO Report”). The 2004 GAO Report summarized the legal environmental disclosure obligations, described the various concerns of what the GAO called “investor organizations” and summarized the GAO’s review of previously prepared studies and interviews of certain relevant representatives of affected companies and the investing public. The 2004 GAO Report came to no conclusions other than to recommend that the SEC improve its tracking and transparency of environmental disclosures and comments and that it take advantage of relevant information available from the EPA. Once these recommendations are implemented and the results are analyzed and fully understood (a process likely to take quite some time), it is possible that the SEC will determine that either the existing requirements are meeting the needs of the investing public or that additional enforcement may be appropriate. In addition, the SEC may re-evaluate the existing requirements and implement new regulations or issue clarifying guidance.

- **Violations of Environmental Disclosure Rules Can Be Costly**

A failure to comply with the SEC disclosure rules can lead to SEC investigations, fines and penalties and litigation. Violations, however, may become more costly and damaging in the future – the Sarbanes-Oxley Act increased the monetary fines and other sanctions that could be imposed on companies and their officers for securities law violations.
B. Executive Summary

A duty to disclose actual or potential environmental liabilities may arise under:

- the specific disclosure requirements of Regulation S-K promulgated under the Securities Act of 1933, as amended (the “Securities Act”);
- the general antifraud provisions of the Securities Act or the Securities Exchange Act of 1934 (the “Exchange Act”); and
- the requirements of Form 20-F, as regards to foreign private issuers filing annual reports or registration statements pursuant to the Securities Act or the Exchange Act.

While it is impossible to summarize all the relevant environmental requirements in a bullet point format, and we therefore encourage you to read this entire memorandum, the key items a public company must disclose are generally:

- Any environmental matter that might have a material effect on its business, liquidity or financial condition.
- Any other material information necessary to make its disclosure not misleading.

Specifically, with respect to its financial statements and/or related narrative disclosure:

- Any known trend, event or uncertainty that, if came to fruition, the company believes would have a material effect on its financial condition or results of operation must be disclosed.
- Details of any off-balance sheet transaction or contractual arrangement that either materially affects or is reasonably likely to materially affect its financials must also be disclosed.
- Environmental accounting policies, if “critical”, should be described.
- Contingent environmental liabilities may need to be reflected, on a gross (not a net) basis, in financial statements and the nature of that accrual (including uncertainties relating to the accrued amount) may need to be described in the accompanying footnotes.

With respect to the company's business description and description of litigation, the following must also be disclosed:

- The effects compliance with environmental laws may have on its capital expenditures, earnings and competitive position, and the actual amounts budgeted for such compliance, if material.
• Any legal proceeding:
  o involving a domestic governmental agency and a potential fine or penalty in excess of $100,000;
  o that could result in costs to the company in excess of ten percent of its current consolidated assets; or
  o that is otherwise material to the company’s business or financial condition.

This memorandum provides a more thorough discussion of all of these rules, including what “material” may mean in the particular context in which the term is used.

Specifically, Section II describes Item 101 of Regulation S-K, which requires companies to disclose the material effects that compliance with environmental laws may have on capital expenditures, earnings and competitive position. Item 101 also requires companies to disclose material future capital expenditures. As discussed in Section II, Item 103 of Regulation S-K requires companies to disclose (i) legal proceedings that (a) are material or (b) could result in monetary sanctions or costs in excess of 10% of the company’s current consolidated assets and (ii) governmental proceedings that could result in monetary sanctions greater than or equal to $100,000. Section II also describes Item 303 of Regulation S-K, which requires companies to disclose material events or uncertainties that would cause that company’s financial statements to not be necessarily indicative of future results or future financial condition. The section ends with a description of the relevant provisions of Form 20-F that require environmental disclosure.

Section III describes the relevant provisions of the Sarbanes-Oxley Act. In particular, Section III describes the requirement that principal executive and financial officers certify to the accuracy of their company’s disclosure. The section also describes the obligations of in-house and outside counsel to report violations of securities laws or similar violations, including of environmental laws, “up the corporate chain”. Companies are also required to disclose material “off-balance sheet” transactions and long-term contingent obligations, both of which could require the disclosure of environmental liabilities or obligations. Proposed rules calling for companies to disclose their critical accounting policies could result in companies being required to provide even more environmental disclosure. Finally, the section describes the SEC’s mandate to review corporate disclosure on a “regular and systematic” basis.

Section IV describes the general antifraud provisions of the Securities Act and the Exchange Act. The section describes certain SEC proceedings that have addressed the question of whether companies must disclose environmental conditions, violations or policies that have not yet been the subject of formal proceedings, but which could lead to liability. The section also describes a recent SEC proceeding brought for inadequate environmental disclosure. In addition, the

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section describes existing case law interpreting environmental disclosure requirements. These cases suggest that companies are required to disclose material liabilities only, and not every minor but related detail or fact.

Companies may be required to recognize certain contingent environmental liabilities in their financial statements. In a series of rulings, releases and bulletins, the SEC, the Financial Accounting Standards Board (the “FASB”) and the American Institute of Certified Public Accountants (“AICPA”) have examined, among other things, when liabilities must be disclosed and accrued for, and whether liabilities can be offset against anticipated recoveries. These pronouncements affect significantly the way in which companies should account for environmental liabilities. Section V examines key accounting rulings, releases and bulletins, including:

(i) FAS 5, which requires companies to accrue a liability if that liability is probable and reasonably estimable;

(ii) FIN 14, which requires companies, with respect to any environmental liability, to accrue the best estimate within a range of estimates or, if none is best, to accrue the minimum;

(iii) EITF 93-5 and SOP 96-1, which require companies to evaluate environmental liabilities independently from any related claims for recovery and provide that claims for recoveries can be factored into the analysis only if they are probable; and

(iv) SAB 92, which states that it is ordinarily inappropriate to offset a contingent liability against a related claim for recovery, even if the recovery is probable. SAB 92 also provides guidance as to what types of information should be included in the footnotes to financial statements.

Section VI describes in more detail the concerns raised by the EPA, certain not-for-profit groups, the GAO and the SEC over the adequacy of environmental disclosures.

Section VII provides some practical guidance for companies to help them comply with the complicated environmental disclosure requirements in this era of increased corporate scrutiny.

Finally, Section VIII sets forth conclusions to this memorandum.

II. SPECIFIC DISCLOSURE REQUIREMENTS

Regulation S-K sets forth specific requirements for the disclosure that a company must make in its registration statements filed pursuant to the Securities
Act and in its periodic reports and proxy and other information statements filed under the Exchange Act.

A. Item 101 — Description of Business

Item 101(c)(1)(xii) of Regulation S-K sets forth two requirements for disclosure of environmental matters affecting a company’s business. The first requires disclosure of “the material effects that compliance with federal, state and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position” of the company and its subsidiaries. The second requires disclosure of “any material estimated capital expenditures for environmental control facilities for the remainder of [the company’s] current fiscal year and its succeeding fiscal year and for such further periods as the [company] may deem material.”

In 1979, the SEC published an interpretive release in which it defined “material” in the context of Item 101(c)(1)(xii) by reference to the definition provided in Securities Act Rule 405 and Exchange Act Rule 12b-2. These definitional rules, using almost identical language, provide that information is “material” if there is a substantial likelihood that a reasonable investor would view the information as important in making an investment decision.

The language of Item 101(c)(1)(xii) only mandates a specific estimate of capital expenditures for a two-year period (consisting of the current and succeeding fiscal years) and for such further periods as the registrant may deem to be material. Item 101(c)(1)(xii) is silent, however, with respect to a time period for which material expenses for compliance with environmental regulations must be disclosed. The 1979 Interpretive Release, however, seems to apply this two-year period to foreign issuers, in particular, annual reports or registration statements filed pursuant to the Exchange Act and a substantial portion of disclosure in registration statements filed pursuant to the Securities Act, may not be subject to Regulation S-K. See Section II.D of this memorandum for additional information.

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(continued...)
year requirement to expenses (such as fines and penalties) incurred in complying with environmental regulations.\(^5\) The release does not clearly state this, however, and could arguably be read to require the disclosure of compliance expenses for the two-year period only if necessary to prevent the disclosure from being misleading. The less than precise 1979 Interpretive Release language reads as follows:

\[
\text{[I]f the registrant has estimates suggesting that after the two-year period there will nevertheless remain material capital expenditures necessary to comply with [environmental regulations], or material penalties or fines for non-compliance are reasonably likely to be imposed if compliance is not achieved, disclosure of such additional known or estimated costs, penalties or fines may be necessary to prevent the mandatory disclosure from being misleading.}\(^6\)
\]

Regardless of whether or not the “two-year period” also applies to expenses for compliance with environmental regulations, it is clear that if the registrant believes the costs of compliance with environmental regulations, whether in the form of expenses or capital expenditures, may be material, those costs should be disclosed in sufficient detail to ensure that the investor understands the importance of the disclosure. In addition to possibly preparing and disclosing cost estimates, it may also be necessary for the company to set forth the basis for its estimates, the assumptions and methods used in reaching such estimates, and the extent of uncertainty that projected future costs may be expended in order for the disclosure not to be misleading.\(^7\)

In SAB 92, the SEC briefly mentions additional disclosure that might be required under Regulation S-K to “enable a reader to understand” the environmental contingencies facing the registrant. Specifically, the registrant may be required to provide a separate description of

\[(i)\quad \text{recurring costs associated with managing hazardous substances and pollution in on-going operations},\]

\[(ii)\quad \text{capital expenditures to limit or monitor such substances or pollutants},\]

\[(iii)\quad \text{mandated expenditures to remediate previously contaminated sites},\]

\[\text{and}\]

\(^5\) 1979 Interpretive Release, supra note 3, at 17,203-5.


\(^7\) 1979 Interpretive Release, supra note 3, at 17,203-5.
B. Item 103 — Legal Proceedings

Item 103 of Regulation S-K mandates disclosure of certain types of legal proceedings in which a company is involved. This section requires disclosure only of actions that have actually been brought or that are known by the company to be contemplated by governmental authorities or private parties. It does not require disclosure of potential actions which could be brought (but which have not been brought and which are not known to be contemplated) against the company for violations of environmental law or the existence of conditions that could give rise to liability. In addition, this provision does not require disclosure of proceedings that are completed prior to the reporting date.

Item 103 provides generally that any material pending legal proceedings, “other than ordinary routine litigation incidental to the business,” must be described by the company. However, Instruction 5 to Item 103 specifically provides that environmental litigation is not to be considered “ordinary routine litigation incidental to the business” and instead mandates disclosure of three different types of environmental litigation:

(i) any proceeding which is material to the business or financial condition of the company;

(ii) any proceeding which involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income and the amount involved, exclusive of interest and costs, exceeds ten percent of the current assets of the company and its subsidiaries on a consolidated basis; or

(iii) any administrative or judicial proceeding to which a governmental entity is a party and such proceeding involves potential monetary sanctions, unless the company reasonably believes the proceeding will result in no monetary

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8 Accounting and Disclosures Relating to Loss Contingencies, Staff Accounting Bulletin No. 92, 58 Fed. Reg. 32,843, 32,845 (June 14, 1993) [hereinafter “SAB 92”]. SAB 92 is discussed in greater detail in Section V of this memorandum.


10 Note that the following analysis also applies to those businesses using the SEC’s small business disclosure system. Regulation S-B, Item 103, 17 C.F.R. § 228.103 (2004).

11 A company may nevertheless be required to disclose, pursuant to the requirements of Item 303 of Regulation S-K or under the general antifraud provisions, the possibility that enforcement actions or other proceedings could be brought against it as the result of its violations of environmental regulations or as a result of environmental conditions which could give rise to material liability. See Sections II.C and IV of this memorandum for more information.

12 17 C.F.R. § 229.103 (2004). Such description must include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought.
sanctions, or in monetary sanctions of less than $100,000, exclusive of interest and costs.13

The instruction thus sets out three independent bases for the disclosure of environmental proceedings: the proceeding is material or the amount involved exceeds ten percent of current consolidated assets or it is a governmental proceeding involving monetary sanctions of $100,000 or more.

1. Is There an Environmental “Proceeding”? In the 1979 Interpretive Release, the SEC explained its view of the types of environmental “proceedings” required to be disclosed by Item 103. Stating that it had never adopted a narrow definition of the types of administrative proceedings required to be disclosed, the SEC noted that governmental enforcement actions may take a number of different forms, including issuance of informal or formal notices of violation, administrative orders, civil suits in which a party seeks injunctive relief and civil fines, or criminal prosecutions. In addition, “administrative proceedings” could be initiated by the company as well as by the government.14

The SEC also noted that it interprets the term “proceeding” to include “all administrative orders relating to environmental matters, whether or not those orders literally follow a ‘proceeding.’”15 The release recognizes that a situation may arise in which a corporation consents to the entry of, or negotiates the terms of, an order against it, yet such an order may not be established through a formal proceeding. The release states unequivocally, however, that this type of order must be disclosed, despite the absence of a formal proceeding, because “the consequences of an administrative consent order, just as those of a judicial consent order, may be just as significant as the consequences of a fully litigated proceeding.”16

Disclosure of actual or contemplated proceedings must include the nature of the relief sought.17 In the 1979 Interpretive Release, SEC stated that it does not consider mere disclosure that the government seeks to compel new pollution control efforts to constitute adequate disclosure of relief sought. Instead, the [SEC’s] regulations contemplate that an estimate of the level of expenditures required to install the pollution control equipment sought by

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13 Id. at § 229.103, Instruction 5.
14 See 1979 Interpretive Release, supra note 3, at 17,203-6 n.14. Note, however, that one court has ruled that a notice of violation is not, per se, a “proceeding” because such notices often lead to a negotiated settlement. Crouse-Hinds v. Internorth, Inc., 518 F. Supp. 416, 474-475 (N.D.N.Y. 1980).
15 1979 Interpretive Release, supra note 3, at 17,203-6.
16 Id.
17 See id.
the governmental authority be provided if such expenditures are likely to be material.\(^{18}\)

2. **Three-Prong Disclosure Test**

(i) **Materiality.** The first prong of the disclosure test under Item 103—disclosure of proceedings material to the business or financial condition of the company—uses the materiality standard set forth in Securities Act Rule 405. A proceeding is material and thus should be disclosed if there is a substantial likelihood that a reasonable investor would attach importance to the information in making an investment decision.\(^{19}\) This requirement can be invoked in a number of ways. For example, in *Wielgos v. Commonwealth Edison Company*\(^{20}\) a shareholder, Wielgos, charged that Commonwealth Edison (the “Company”) violated Item 103 by failing to disclose in its registration statement that its application for a license to operate a nuclear power plant (Byron 1) was pending before the Atomic Safety Licensing Board (the “ASLB”), a division of the Nuclear Regulatory Commission (the “NRC”). In January of 1984, the ASLB “did something it had never done before . . . it denied the application outright, implying that Byron 1 must be dismantled.”\(^{21}\) Commonwealth Edison’s stock price fell the next day, but rebounded after an appeals board reversed the ASLB’s denial of the license. Wielgos filed suit between the time of denial and the reversal.

Wielgos charged that the Company was required to disclose the pending application pursuant to Item 103, stressing that Instruction 5(B) (relating to the ten percent test) was particularly relevant. The district court found that disclosure was not required because the “status of the application was not ‘material.’”\(^{22}\) The appeals court interpreted materiality to depend “not only on the magnitude of an effect but also on its probability.”\(^{23}\) Since the likelihood that the ASLB would deny the application outright was extremely small, the court reasoned, the proceeding was not material, even though the costs of denial could be quite high.

The Seventh Circuit chose not to follow the lower court’s reasoning. Rather, it decided the case “without regard to materiality,” reasoning that Commonwealth Edison had disclosed the proceeding in sufficient detail to comply with the requirements of Item 103. The Company had disclosed that it was building five nuclear reactors and was applying for operating licenses from the NRC. The Company also disclosed that environmental groups were opposing its applications for licenses. The court stated:

\(^{18}\) *Id.* This interpretation arose out of a proceeding against U.S. Steel. See *In re U.S. Steel*, *supra* note 6, at 82,384.


\(^{20}\) 892 F.2d 509 (7th Cir. 1989).

\(^{21}\) *Id.* at 510.

\(^{22}\) *Id.* at 517.

\(^{23}\) *Id.*
What it did not say is that the application for Byron 1 was before the ASLB rather than some other part of the NRC, and that if the ASLB denied its application costs would go up while it tried to obtain a reversal. This is rather like revealing pending litigation without saying that the case is pending before a magistrate, and that costs will go up if the magistrate should make an adverse (and erroneous) but influential recommendation.\textsuperscript{24}

The company did not have to reveal that the application for Byron 1 was before the ASLB because “Item 103 does not call on registrants to describe the internal organization of courts or administrative bodies or even to state the status of the pending case.”\textsuperscript{25}

(ii) \textit{Ten Percent Test}. The second prong of the disclosure test requires identification of any proceeding which “involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income and the amount involved, exclusive of interest and costs, exceeds 10 percent of the current assets of the [company] and its subsidiaries on a consolidated basis.”\textsuperscript{26} An environmental proceeding is generally more likely to trigger this economic materiality standard than is a non-environmental proceeding because environmental proceedings often involve potentially large fines and remedial costs which may exceed ten percent of the current consolidated assets of a company.\textsuperscript{27}

In applying the ten percent test, a company must aggregate actions that present “in large degree the same legal and factual issues as other proceedings pending or known to be contemplated.”\textsuperscript{28} In other words, if a number of actions have been instituted by or against a company and those actions are sufficiently similar legally and factually, the company must aggregate the potential liabilities from all such actions to determine whether its total potential liability exceeds ten percent of its current consolidated assets.

The SEC included “deferred charges or charges to income” in the ten percent test “to encompass those situations in which, for example, the [company] chooses to shut down a relatively insignificant plant, rather than make the necessary capital expenditures, and therefore must make a charge against income.”\textsuperscript{29}

\textsuperscript{24} \textit{Id}.

\textsuperscript{25} \textit{Id.} It is interesting to note that both the district court and the circuit court assumed without any discussion that an application for a license is a “proceeding” under Item 103.

\textsuperscript{26} 17 C.F.R. § 229.103 Instruction 5(B) (2004).

\textsuperscript{27} \textit{See} Caron, \textit{supra} note 19, at 745.

\textsuperscript{28} 17 C.F.R. § 229.103 Instruction 2 (2004).

If the ten percent threshold is met, a company must disclose all potential costs arising from an environmental proceeding, whether those costs consist of cleanup costs, other remedial costs, capital expenditures that may be required as the result of the proceeding, or charges against income from the closure of environmentally unsound operations.

(iii) The Government as a Party. The SEC has indicated that the third prong of the test applies only to environmental administrative or judicial proceedings to which a domestic governmental entity is a party.\(^{30}\) Please note, however, that a proceeding involving a foreign government may still be required to be disclosed if it independently satisfies the first or second prong of the Item 103 test.\(^{31}\)

The provision addressing proceedings to which the government is a party presents a few more complications than the other two prongs of the Item 103 disclosure test. Instruction 5(C) to Item 103 includes a “reasonable belief” standard under which there is no disclosure duty if the company reasonably believes that the action will result in monetary sanctions of less than $100,000. The SEC has explained that the $100,000 threshold does not “automatically require disclosure of any proceeding in which the possible maximum fine which could be imposed is $100,000 or more, but rather . . . permit[s companies] to consider both the amount of any potential fine and the probability that this maximum penalty, as opposed to a lesser fine, actually will be imposed.”\(^{32}\)

The SEC has stated that the company’s “reasonable belief would have to exist at the time the disclosure document is filed, and such belief would have to be reevaluated in connection with future filings if circumstances change with respect to a particular proceeding.”\(^{33}\)

The reasonableness test is composed of both a subjective and an objective element. A company must actually hold a belief that the fines will total less than $100,000 and that belief must be reasonable under the circumstances known to the company at the time.\(^{34}\) A company cannot defend itself with the argument that its


\(^{32}\) Proposed Amendments, supra note 29, at 84,288.

\(^{33}\) Id. A commentator has noted two ways in which a company can increase the likelihood that its belief about the amount of potential fines is reasonable: first, in estimating possible penalties, the company should review the course and outcome of its prior dealings with the government on similar issues; second, the company should examine the results of similar proceedings involving other companies. See Caron, supra note 19, at 747.

\(^{34}\) See Caron, supra note 19, at 747 n.160.
judgment was made in good faith if the SEC determines that, given the facts
known by the company, the judgment was unreasonable.35

Instruction 5(C), unlike Instructions 5(A) and 5(B), does not require a
company to aggregate similar proceedings to determine if, grouped together, they
could result in penalties of more than $100,000.36 The SEC rejected the
aggregation approach for purposes of the Instruction 5(C) test to avoid imposing
on companies “a burdensome data collection and evaluation effort.”37 Although
Instruction 5(C) does not mandate aggregation for purposes of applying the
disclosure test, it does permit a company to group, and describe generically,
similar proceedings which individually meet the disclosure threshold.

Companies often have to face the question of whether disclosure is
required when a company has been designated a potentially responsible party (a
“PRP”) either by the EPA under the Comprehensive Environmental Response,
Compensation, and Liability Act of 1980 (“CERCLA” or “Superfund”) or pursuant
to a similar state statute. Two particular issues are raised by that question: (a) is
there a proceeding to which the government is a party? and (b) are the costs of
remediating a Superfund site “sanctions”?38

According to a 1989 release,38 “[d]esignation as a PRP does not in and of
itself trigger disclosure under [Instruction 5 of] Item 103 . . . because PRP status
alone does not provide knowledge that a governmental agency is contemplating a
proceeding.”39 Although designation alone does not trigger a disclosure duty
under Instruction 5, the SEC goes on to warn that the “particular circumstances
[of a company], when coupled with PRP status, may provide that knowledge.”40 Thus,
if a company has been designated as a PRP and its particular circumstances
suggest that the government is in fact contemplating a proceeding against it, the
company must determine whether such proceeding satisfies any prong of the Item
103 test.

The SEC also considered whether the costs of remediation associated with
a Superfund site constitute “sanctions” within the meaning of Instruction 5(B) (the
ten percent test) or Instruction 5(C) (the government-as-party test). The release
states:

35 See id. at 747.
37 Id.
38 See Management’s Discussion and Analysis of Financial Condition and Results of
Rep. (CCH) ¶ 72,436 (relevant section reproduced at Fed. Sec. L. Rep. (CCH) ¶ 73,193, at 62,844
n.17) (May 18, 1989) [hereinafter “MD&A”]. Although this release focuses on the disclosure
required in the MD&A section, it also provides guidance in interpreting Item 103.
39 Id. A company may, of course, independently be required to disclose its designation as a
PRP under either Item 101 or Item 303 of Regulation S-K.
40 Id.

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While there are many ways a PRP can become subject to potential monetary sanctions, including triggering the stipulated penalty clause in a remedial agreement, the costs anticipated to be incurred under Superfund, pursuant to a remedial agreement entered into in the normal course of negotiation with the EPA, generally are not “sanctions” within either Instruction 5(B) or (C) to Item 103. Such remedial costs normally would constitute charges to income, or in some cases capital expenditures.\textsuperscript{41}

Although the release may absolve a company named as a PRP from a disclosure duty under the government-as-party test of Instruction 5(C), the company may nevertheless have a disclosure obligation if the company’s share of the clean up costs at the site (as a charge to income or as a capital expenditure) meets the ten percent test of Instruction 5(B) or is otherwise material.

In determining its disclosure duty under Instruction 5(A) or 5(B), a PRP may consider the “availability of insurance, indemnification or contribution.”\textsuperscript{42} In assessing its exposure, the PRP must consider the creditworthiness of the indemnitor or other potential contributing parties, the nature and amount of insurance coverage and the likelihood that litigation may be necessary to compel payment or contribution.\textsuperscript{43}

C. Item 303 — Management’s Discussion and Analysis of Financial Condition and Results of Operations

Item 303 of Regulation S-K\textsuperscript{44} generally requires a company to disclose “material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.”\textsuperscript{45}

Although Item 303 does not refer expressly to disclosure of environmental matters, the SEC issued a 1989 interpretive release in which it used a potential environmental liability to illustrate the requirements of Item 303.\textsuperscript{46} In the release, the SEC attempted to clarify the distinction set out in Item 303 between two types


\textsuperscript{42} Id. The availability of insurance and indemnification is relevant not just in situations in which a company has been designated as a PRP, but in all situations in which contribution, insurance and/or indemnification may be a factor. For a discussion of such recoveries in the context of financial statements, see Section V of this memorandum.

\textsuperscript{43} In a letter issued prior to Securities Act Release No. 6835, the SEC clarified that the issue of indemnification is not relevant in disclosures pursuant to Instruction 5(C) because that item only requires disclosure of sanctions, not remedial costs. See Cole. Note, however, that the existence of an indemnification might be an issue in financial statement disclosure. See Section V of this memorandum.

\textsuperscript{44} 17 C.F.R. § 229.303 (2004).

\textsuperscript{45} Id. at § 229.303(a), Instruction 3.

\textsuperscript{46} MD&A, supra note 38, at 62,844.
of forward-looking information: (i) “prospective information,” which a registrant must disclose, and (ii) “voluntary forward-looking information,” disclosure of which is optional.\textsuperscript{47} It stated that prospective information is information “based on currently known trends, events, and uncertainties that are reasonably expected to have material effects” on the company’s business, financial position or results of operations, while voluntary forward-looking information involves “anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty.”\textsuperscript{48} Essentially, voluntary forward-looking information is less certain than prospective information.

In the release, the SEC identified a two-step test for determining whether information is prospective information which must be disclosed:

(i) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(ii) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur.\textsuperscript{49}

The SEC then presented the following hypothetical situation to which it applied these principles:

\textit{Facts:} A registrant has been correctly designated a PRP by the EPA with respect to cleanup of hazardous waste at three sites. No statutory defenses are available. The registrant is in the process of preliminary investigations of the sites to determine the nature of its potential liability and the amount of remedial costs necessary to clean up the sites. Other PRPs also have been designated, but the ability to obtain contribution is unclear, as is the extent of insurance coverage, if any. Management is unable to determine that a material effect on future financial condition or results of operations is not reasonably likely to occur.

\textit{[Answer:]} Based upon the facts of this hypothetical case, MD&A disclosure of the effects of the PRP status, quantified to the extent reasonably practicable, would be required. For MD&A purposes, aggregate potential cleanup costs must be considered in light of the joint and several liability to which a PRP is subject. Facts regarding whether insurance coverage may be contested, and whether and to what extent potential sources of contribution or indemnification constitute reliable sources of

\textsuperscript{47} MD&A, \textit{supra} note 38, at 62, 842.

\textsuperscript{48} \textit{Id}.

\textsuperscript{49} \textit{Id}. at 62,843. The SEC further reminded registrants that each final determination resulting from management’s assessments must be objectively reasonable, as viewed at the time the determination is made.
recovery may be factored into the determination of whether a material future effect is not reasonably likely to occur. 50

This materiality test for MD&A disclosure differs from the materiality test under the general antifraud provisions in some respects. The general antifraud materiality test requires a company to weigh the probability and magnitude of a possible future event to determine whether it must be disclosed. 51 The MD&A materiality test requires disclosure if the Company cannot conclude (i) that the event, trend or uncertainty is not reasonably likely to occur or (ii) assuming occurrence, that a material future effect is not reasonably likely to occur. 52

As the SEC notes, Item 303 requires a company to consider the maximum Superfund liability it might incur under joint and several liability. The company may, however, then be able to take into account the extent to which it will be able to obtain contribution or indemnification from other PRPs or obtain coverage from its insurance carrier in determining whether or not disclosure is required. 53

Although case law relating to environmental disclosure required pursuant to Item 303 is sparse, one recent decision suggests that companies should pay close attention to certain “boilerplate” language often used in presenting forward-looking information. In Endo v. Albertine, 54 the plaintiffs filed a complaint against various officers, directors, accountants, investment advisors and underwriters of Fruit of the Loom, Inc. alleging, among other matters, that a registration statement and prospectus failed to disclose that the company had retained substantial contingent environmental liabilities in connection with its former subsidiaries. The language in the prospectus stated:

The Company and its subsidiaries are parties to certain legal proceedings and have retained certain liabilities with respect to the sale of certain discontinued operations, including “Superfund” and other environmental liabilities. The Company believes that these matters will not have a material effect on its business or financial condition. 55

While the court held that the language “[t]he Company believes that these matters will not have a material effect on its business or financial condition” was

50 Id. at 62,844.
51 See id. at 62,843, n.14 (citing Basic, Inc. v. Levinson, 485 U.S. 224 (1988)).
52 The SEC has stated that the disclosure threshold of “reasonably likely” is lower than “more likely than not”. Commission Statement about Management’s Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 805 6, 2002 SEC LEXIS 148 (January 22, 2002) [hereinafter “2002 MD&A Statement”].
53 But see Section V of this memorandum for a discussion of accrual of contingent liabilities and financial disclosure.
55 Id. at 714-15 (emphasis added).
protected by Securities Act Rule 175 as a forward-looking statement,\textsuperscript{56} it nonetheless denied defendants’ summary judgment motion, noting that plaintiffs had presented evidence that raised inferences that the statement lacked a reasonable basis in fact and was not made in good faith. Plaintiffs’ evidence indicated that defendants failed to disclose that the company might be potentially responsible for $60 million of environmental liabilities. While, as noted above, the defendants did state that the company had retained certain environmental liabilities from the sale of a subsidiary, the court found that reasonable minds could differ on the question of whether the omission of the magnitude of these liabilities was material to the investors.\textsuperscript{57} Therefore, the boilerplate statement that “the Company believes” the matters will not be material was not necessarily sufficient disclosure as a matter of law, and the issue could not be resolved on summary judgment.

As a result of recent amendments to Item 303 required by Sarbanes-Oxley, Item 303 now requires registrants to disclose certain off-balance sheet obligations and long-term contractual obligations. See Section III.C of this memorandum for a description of these new requirements and the impact they may have on environmental disclosure obligations. Section III.D describes a proposed amendment to Item 303 which would require companies to disclose and describe, in their MD&A sections, critical accounting estimates.

D. Form 20-F Disclosure Requirements on Foreign Private Issuers

Form 20-F, like Regulation S-K, sets forth specific requirements for the disclosure that “foreign private issuers” must make in their annual reports filed pursuant to Section 13 or 15(d) of the Exchange Act, registration statements filed pursuant to Section 12 of the Exchange Act and registration statements on Form S-1 filed pursuant to the Securities Act.\textsuperscript{58}

1. Item 4.D – Environmental Issues Affecting a Material Asset. The only specific provision of Form 20-F which calls for the disclosure of environmental matters is contained in Item 4.D, Company Information, Property, Plant and Equipment. Item 4.D requires issuers to provide “information regarding any material tangible fixed assets, including leased properties”, including a...

\textsuperscript{56} Rule 175 is a so-called “safe harbor” rule protecting both kinds of forward-looking statements (prospective information and voluntary forward-looking information), if they meet certain criteria. No such statement shall be deemed to be fraudulent unless it is shown that “such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.” 17 C.F.R. § 230.175(a). A “forward-looking statement” means, among other things, a statement containing a projection of “revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items.” 17 C.F.R. § 230.175(c)(1).

\textsuperscript{57} Endo, 863 F. Supp at 720. The court discounted the fact that the nature and amount of such liabilities had previously been disclosed in newspaper articles. \textit{Id}.

\textsuperscript{58} To view Form 20-F, see http://www.sec.gov/about/forms/form20-f.pdf. “Foreign private issuers”, defined in Rule 3b-4 of the Exchange Act, are, generally, companies whose equity securities and assets are beneficially owned, or located, primarily by non-U.S. persons or outside of the U.S. Foreign private issuers are permitted to incorporate by reference the disclosure contained in their 20-F filings into certain registration statements filed pursuant to the Securities Act.
description of “any environmental issues that may affect the company’s utilization of the assets”. This provision, as drafted, would appear to require disclosure of all issues, material or not, relating to any material asset.

2. **Other Disclosure Requirements.** Form 20-F contains other provisions that may require a foreign private issuer to disclose environmental liabilities. These provisions are similar to those set forth in Regulation S-K and summarized in Sections II.A, II.B and III.C above. For instance, Item 4.B, Business Overview, requires companies to disclose the material effects of governmental regulation on their businesses. Item 5.B, Liquidity and Capital Resources, requires companies to disclose information regarding their material commitments for capital expenditures as of the end of the latest financial year and any subsequent interim period. Item 5.D, Trend Information, requires the disclosure of any known trends, uncertainties, demands, commitments or events that are reasonably likely to have a material effect on the companies’ net sales or revenues, income from continuing operations, profitability, liquidity or capital resources, or that would cause reported financial information to be not necessarily indicative of future operating results or financial condition. Finally, Item 8.A, Consolidated Statements and Other Financial Information, requires the disclosure of any legal proceedings, pending or known to be contemplated, which may have, or have had in the recent past, “significant effects on the company’s financial position or profitability”.

3. **Financial Statements.** Item 17 of Form 20-F (Financial Statements) directs foreign private issuers to provide financial statements that disclose “an information content substantially similar to financial statements that comply with U.S. generally accepted accounting principles and Regulation S-X”. The financial statements may be prepared according to a comprehensive body of accounting principles other than those generally accepted in the United States if certain additional information is disclosed, including a description of certain variations between the methods used to prepare the financial statements and those generally accepted in the United States.

III. **ENVIRONMENTAL ASPECTS OF SARBANES-OXLEY ACT OF 2002**

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act into law. The Act generally applies to any company (including any non-U.S. company) that has filed a registration statement under the Securities Act or is required to file periodic reports under the Exchange Act.

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59 As a result of the Sarbanes-Oxley Act, Form 20-F now includes new Items 5.E and 5.F, which, consistent with amended Item 303 of Regulation S-K, requires companies to disclose certain off-balance sheet arrangements and to provide tabular disclosure of contractual obligations.

60 Item 17, Form 20-F, supra note 58.

61 See Section V of this memorandum for a description of the most significant environmental disclosures required under U.S. generally accepted accounting principles.
The civil provisions of the Sarbanes-Oxley Act are largely composed of requirements that the SEC issue certain rules or take certain actions within specific time frames. Except where otherwise noted in this memorandum, the rules promulgated by SEC under the Sarbanes-Oxley Act have been adopted in final form.

A. **CEO and CFO Certifications**

In 2002, the SEC adopted, pursuant to Section 382 of the Sarbanes-Oxley Act, new Exchange Act Rules 13a-14(d), 13a-15, 15d-14(d) and 15d-15 and Item 308 of Regulation S-K and 15d-14(d) requiring principal executive and financial officers to certify, in each periodic report (including annual reports on Form 20-F), that they:

(i) have reviewed the report and, based on their knowledge, (a) the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made to be not misleading and (b) the financial information in the report fairly presents in all material respects the financial condition of the company;

(ii) are responsible for the company’s disclosure controls and procedures and have designed or have caused to be designed such disclosure controls and procedures to ensure that material information is made known to them;

(iii) have evaluated the effectiveness of the disclosure controls and procedures and presented conclusions about the effectiveness of the disclosure controls and procedures in the report;

(iv) have disclosed in the report changes to internal control over financial reporting that have materially affected or are reasonably likely to materially affect the company’s internal control over financial reporting; and

(v) have disclosed to the auditors and audit committee (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company’s ability to record, process, summarize and report financial

62 The criminal provisions of the Sarbanes-Oxley Act, in relevant part, include a new criminal antifraud provision, making it a crime to engage in a scheme or artifice to defraud any person in connection with any security registered under the Exchange Act, or to obtain by false means any money or property in connection with the purchase or sale of any security of a public company. This provision broadens the basis for criminal prosecution of securities fraud. Section 1106 of the Sarbanes-Oxley Act increases the potential penalties and sanctions for knowing and/or willful violations of the Exchange Act. Also, as described in Section III.A of this memorandum, Section 902 of the Sarbanes-Oxley Act provides for specific criminal penalties and sanctions for both knowing or willful violations of that section, which requires CEOs and CFOs to sign certifications.

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This memorandum is a summary for general information only. It may not be relied upon as legal or accounting advice.
information and (b) any fraud involving any employee that has a significant role in the internal control over financial reporting.\textsuperscript{63}

Exchange Act Rules 13a-14(b) and 15d-14(b), which incorporate the requirements of Section 906 of the Act, further require (under pain of criminal sanctions) CEOs and CFOs separately to certify in each periodic report that such report “fully complies” with Exchange Act Section 13(a) or 15(d), and that the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of the company.\textsuperscript{64}

These rules mean that companies, including those with operations around the globe, must be ready to certify that effective disclosure controls and procedures and internal control over financial reporting are in place which ensure that environmental information required to be disclosed by the company is properly gathered, recorded, processed, summarized and reported within the applicable time period, and that such information is accumulated and communicated to management as appropriate to allow timely decisions regarding the required disclosures.

\textbf{B. Standards of Professional Conduct for Attorneys}

Section 307 of the Sarbanes-Oxley Act requires the SEC to prescribe certain minimum standards of conduct for attorneys practicing before the SEC. In January 2003, the SEC adopted a final rule requiring attorneys appearing and practicing before the SEC in the representation of issuers to report evidence of a material violation of securities laws, a material breach of fiduciary duty or a similar material violation by the issuer or its officers, directors, employees or agents to appropriate officers within the issuer and, thereafter, up-the-ladder within the issuer, if the initial report does not result in an appropriate response.\textsuperscript{65}

The final rule applies to both inside and outside counsel, and the phrase “appearing or practicing before the [SEC]” broadly includes anyone that provides advice regarding any statement, opinion or other document the lawyer has notice will be submitted with, or incorporated into, a document filed with or submitted to the SEC. This definition would generally encompass attorneys providing advice or comments with respect to environmental disclosures in SEC filings as well as purchase, loan or other contractual agreements filed as exhibits to any such filings.

The new reporting obligations imposed on counsel hinge on the awareness of evidence of:

\textsuperscript{63} A violation of these certification requirements could result in civil liabilities to purchasers of securities, and, for criminal violations, up to twenty years in prison and a $5 million fine for individuals.

\textsuperscript{64} Section 906, enforced by the Department of Justice, allows for criminal penalties of up to 10 years in prison and a $1 million fine for any “knowing” violation, and 20 years in prison and a $5 million fine for any “willful” violation. 18 U.S.C. § 1350 (2004).

\textsuperscript{65} 17 C.F.R. Part 205. (2004).
(i) a material violation of securities laws;

(ii) a material breach of fiduciary duty; or

(iii) a similar material violation, in each case, under United States law.66

The obligation is triggered if a reasonably prudent and competent attorney would conclude that it is reasonably likely that any of the foregoing events has occurred, is occurring or is about to occur.67 Attorneys with evidence of any such material breach or violation must report this evidence to the chief legal counsel or chief executive officer of the company. The attorney’s obligation does not end with the report itself: he or she must press that report “up the ladder” of the company unless the attorney reasonably believes that he or she has received an “appropriate response” to the report within a reasonable time.68

The SEC may impose civil penalties and remedies as well as the disciplinary authority of the SEC, including censure or suspension or debarment from appearing and practicing before the SEC, if it finds that an attorney violated these rules.69

Under a controversial draft SEC rule proposed in early 2003, an attorney who reasonably believes that no “appropriate response” has been received would be required to disaffirm any submissions such attorney reasonably believes may be materially false or misleading and (in the case of outside counsel) withdraw from the representation and provide the SEC with notice of this withdrawal.70 The proposed rule provides for an alternative disclosure regime that would require the company, and not the attorney, to disclose the attorney’s withdrawal (or notice that the attorney has not received an appropriate response from the issuer) on Form 8-K or Form 20-F within two business days of the receipt of notice from the attorney.

Far from drawing a bright line, the SEC’s new rules – including the proposed and highly controversial “noisy withdrawal” rule – are replete with vague and undefined terms. For the time being, environmental attorneys are left to wonder, for instance, whether a “material violation” refers to financial materiality or some other criterion, and whether “similar material violation” extends to all laws (including environmental laws) or merely obligations akin to securities laws.

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66 17 C.F.R. Part 205.2(i).
67 17 C.F.R. Part 205.2(e).
68 Alternatively, attorneys and chief legal officers may report violations to the company’s qualified legal compliance committee or another committee comprised of independent directors, assuming such committee has been formed. Upon such report, the attorney has no further obligations to assess the response to the report. 17 C.F.R. Part 205.3(c).
69 17 C.F.R. Part 205.6.
and fiduciary duties. Similarly, determining whether an “appropriate response” has been received is likely to involve complex judgment calls based on factual representations and legal determinations made by third parties.

C. Disclosure of Off-Balance Sheet Arrangements and Aggregate Contractual Obligations in MD&A

1. Off-Balance Sheet Arrangements. As mandated by Section 401(a) of the Sarbanes-Oxley Act, the SEC adopted in January 2003 a final rule requiring companies to disclose material off-balance sheet arrangements in the MD&A section of their registration statements, periodic reports and proxy and information statements. Specifically, companies are required to disclose off-balance sheet arrangements that materially affect, or are reasonably likely to have a material effect on, their financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. The disclosure must convey the nature, magnitude, timing and likelihood of risks of loss that are reasonably likely to occur under the off-balance sheet arrangement. Companies are required to disclose these arrangements in filings that include financial statements for fiscal years ending on or after June 15, 2003. These rules also apply to foreign private issuers filing annual reports or registration statements pursuant to Form 20-F.

An “off-balance sheet arrangement” includes, in relevant part, “any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the company is a party,” and under which the company has either:

(i) an obligation under certain guarantee contracts (including most financial and performance guarantees and certain indemnification arrangements);

(ii) “[a] retained or contingent interest in assets transferred to the unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to such entity for such assets”; or

(iii) an actual or contingent obligation arising out of a material “variable interest” in the unconsolidated entity, the value of which interest changes with changes in such entity’s net asset value, if the unconsolidated entity provides financing, liquidity, market or credit risk support to the company, or engages in leasing services with the company.

For instance, it is not uncommon for companies to acquire or hold contaminated assets through unconsolidated special purpose entities. Indeed, a
number of companies have moved environmental liabilities off their balance sheets through the use of structured insurance products or specialized environmental liability transfer companies, in each case by contractually transferring environmental risk to a third party special purpose entity. Depending on the exact nature, size and scope of these arrangements and if these arrangements are not considered to be contingent liabilities arising out of litigation, arbitration or regulatory actions, disclosure under the new Sarbanes-Oxley rules may be required.

2. **Long-Term Contractual Liabilities.** Pursuant to the mandate set forth in Section 401(a) of the Sarbanes-Oxley Act, the SEC adopted in January 2003 a final rule requiring a subject company to disclose all payment amounts due under long term contractual liabilities on its balance sheet.\(^{75}\) A company must disclose the total amount of payments relating to these liabilities, as well as a breakdown of payments due in less than one year, one to three years, three to five years and more than five years. Companies must include this disclosure in all filings that are required to include financial statements for the fiscal years ending on or after December 15, 2003. This rule would require the disclosure of environmental liabilities arising out of the companies’ contractual obligations, if amounts relating to such liabilities are accrued as a long-term liabilities on their balance sheets.\(^{76}\)

**D. Proposed Rule on Critical Accounting Policies**

In December 2001, the SEC issued a reminder to companies to ensure their selection and application of accounting policies be “appropriately reasoned”.\(^{77}\) The SEC noted that, while companies typically identify environmental trends, events and uncertainties in their MD&As, they do not always address the implications those trends, events and uncertainties may have on the company’s estimates, and accordingly, disclosure would be improved if companies better explained the interplay of these uncertainties with their accounting measurements.

As foreshadowed in its December 2001 statement, the SEC issued in May 2002 a proposed rule requiring foreign and domestic companies to include in the MD&A section of their annual and quarterly reports, registration statements and proxy and information statements a separate section entitled “Application of Critical Accounting Policies”.\(^{78}\)

The proposed rule calls for the identification and description of accounting estimates (i) based on assumptions about matters that are highly uncertain and (ii)
for which the company could have reasonably recorded a different amount in the current period, or which are reasonably likely to change from period to period, in each case, to the extent that the different amount or the change would have a material impact on the company’s financial presentation. In addition, companies would be required to (a) explain the impact of each critical accounting estimate on its financial results, (b) provide quantitative disclosures to demonstrate sensitivity, (c) provide quantitative and qualitative disclosure concerning past changes, (d) include a statement of whether senior management has discussed the development and selection of the accounting estimate with the audit committee and (e) separately identify each business segment affected by each of the critical accounting estimates.

If a company is deemed to have any critical environmental accounting policies based on the criteria set forth above, the proposed rule (if adopted) would call for more detailed disclosure of material litigation and environmental contingencies than what is currently mandated under FAS 5 (see Section V.A, infra) and other applicable accounting pronouncements. There is legitimate concern, however, that heightened disclosure regarding such contingent matters will jeopardize confidentiality and attorney-client privilege and impair the company’s ability to settle or compromise such liabilities on favorable terms. 79

E. Rapid Current Disclosure

The Exchange Act requires domestic companies to disclose certain types of information, including changes in control in the company and significant acquisitions or dispositions, pursuant to a current report on Form 8-K. Depending on the nature of the information, companies have within five to fifteen business days from the date of the triggering event to file this disclosure.

Pursuant to Section 409 of the Sarbanes-Oxley Act, the SEC promulgated amendments to Form 8-K, which will become effective on August 23, 2004. The amendments include:

(i) the addition of eight new disclosure items;

(ii) the expansion of certain existing Form 8-K disclosure items; and

(iii) the amendment of the filing deadline for most currently required items from five business or fifteen calendar days to four business days only. 80

The additional disclosure items include (i) the creation of a direct financial obligation or an obligation under an off-balance sheet arrangement, when such


obligations are material, and (ii) the disclosure of any event triggering such obligations.

Companies should be prepared to disclose, on an accelerated basis, obligations stemming from the granting of certain material environmental indemnities, or the assertion by a third party of a material claim under such an indemnity, to the extent such indemnities are financial obligations.

F. Enhanced Review of Public Company Disclosure

Section 408 of the Sarbanes-Oxley Act requires the SEC to review the filings, including financial statements, of every public company, including every foreign private issuer, on a “regular and systematic” basis, and in any event at least once every three years.81 The SEC must consider, among others, the following factors for purposes of scheduling these reviews: (i) issuers that have issued “material restatements” of financial results; (ii) issuers that experience “significant volatility” in stock price; (iii) issuers with the largest market capitalization; and (iv) issuers whose operations “significantly affect any material sector of the economy”.82 The SEC issued a February 2003 report entitled, “Summary by The Division of Corporate Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies”.83 In the summary, the SEC states it has already issued environmental comments to various oil and gas, mining and manufacturing companies, reminding these companies of the accounting guidance set forth in SFAS 5, FIN 14, SOP 96-1 and SAB 92.84

IV. GENERAL ANTIFRAUD PROVISIONS

Sections 11 and 12 of the Securities Act and Section 10 of the Exchange Act (and Rule 10b-5 promulgated thereunder) comprise the “general antifraud provisions” of the securities laws. Sections 11 and 12, among other things, prohibit the making of an untrue statement of a material fact in a registration statement or prospectus or any omission of a material fact required to be stated therein or necessary to make the statements therein not misleading. Section 10 and Rule 10b-5 prohibit fraudulent practices in connection with the purchase or sale of any security.85

82 Id. at §408(b).
84 This is discussed in greater detail in Section VI of this memorandum.
85 Section 804 of the Sarbanes-Oxley Act now extends the statute of limitations for claims involving securities fraud to the earlier of (a) two years after discovery of the fraud or (b) five years after the violation.

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The SEC has used these general antifraud provisions to impose environmental disclosure requirements in certain circumstances that go beyond those identified in Regulation S-K. The SEC has stated:

The Commission’s general reporting rules require disclosure of any additional material information, beyond that for which disclosure is required by specific Commission rule, necessary to make required statements not misleading. In the context of its environmental releases, the Commission has interpreted these rules as requiring disclosure of “all other environmental information of which the average prudent investor might reasonably be informed”.

It remains to be seen whether, in light of the recent corporate scandals and the passage of the Sarbanes-Oxley Act and the SEC rules and regulations mandated by such Act, the SEC will use these provisions more often in enforcement cases involving environmental disclosure.

A. SEC Proceedings Regarding Environmental Disclosure

1. Whether the Disclosure of Environmental Matters Not Yet the Subject of a Formal Proceeding is Required. An especially controversial SEC position on environmental disclosure, based on the general antifraud provisions, concerns a company’s duty to disclose environmental conditions, violations of environmental laws or company environmental policies which have not yet been the subject of formal proceedings but which could lead to liability. The issue was raised but not definitively resolved in the enforcement proceedings brought by the SEC during the 1970’s against Allied Chemical Corporation, Occidental Petroleum Corporation and United States Steel Corporation.

   (i) Allied Chemical Corporation. In 1977, the SEC brought an action against Allied Chemical Corporation (“Allied”) which alleged, among other things, that Allied had violated the antifraud provisions of Sections 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by failing to disclose potential environmental liabilities which could result from the company’s discharge of

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86 See 1979 Interpretive Release, supra note 3, at 17,203-4-17, 203-5 n.11.


88 See Caron, supra note 19, at 751-58.

89 In these three enforcement proceedings, the SEC alleged violations of both the general antifraud provisions and the then form of Regulation S-K which required disclosure of all contemplated administrative or judicial proceedings arising under environmental laws to which a governmental authority was a party, instead of the current form of Item 103 of Regulation S-K which only requires disclosure of proceedings involving potential monetary sanctions of $100,000 or more. Although disclosure of specific items in these proceedings might not be mandated under the current form of Item 103, these cases are still important precedents for determining whether certain disclosure is required under the materiality standard set forth in Regulation S-K and the general antifraud provisions.
Kepone and other toxic chemicals into the environment. According to the SEC, “[d]uring the time that Allied was discharging toxic chemicals, it knew that tests showed that animal and marine life which ingested Kepone suffered adverse effects. As a result, Allied was exposed to material potential financial liabilities from companies[,] individuals, and state and local governments exposed to significant amounts of Kepone.” Thus, the SEC argued that Allied violated the disclosure rules when it did not disclose activities which it knew were harmful to human health and to the environment and could lead to material financial liabilities even though no enforcement actions against it had been commenced or were, to Allied’s knowledge, contemplated. Under the terms of a consent order entered simultaneously with the filing of the complaint, Allied consented to a permanent injunction against further violations of the disclosure provisions of the securities laws and undertook an investigation of its potential environmental liabilities.

(ii) **Occidental Petroleum Corporation.** In a similar enforcement action against Occidental Petroleum Corporation (“Oxy”), the SEC charged that Oxy failed to disclose certain potential liabilities of its wholly owned subsidiary, Hooker Chemical Corporation (“Hooker”), resulting from the leaching into the environment of wastes from three chemical disposal sites: Love Canal, Hyde Park Landfill and the S-Area Landfill.

The SEC asserted that by at least 1977 (the precise date varying with respect to the specific site), Hooker was exposed to material potential liabilities as a result of its ownership and use of these sites. Under the circumstances, the SEC asserted that Oxy should have timely disclosed these potential liabilities, reasonably ascertainable amounts of potential exposure and costs associated therewith and other relevant facts in several of Oxy’s filings with the SEC. The following is a discussion of the relevant facts surrounding each of these three sites.

(a) **Love Canal:** Hooker had dumped chemical waste into Love Canal for a period of ten years from 1942 to 1952. In 1953, the site was deeded to the Board of Education of the School District of the City of Niagara Falls, at the Board’s request. In 1977, the media began to focus attention on environmental conditions at the site and the City of Niagara Falls hired the Calspan Corporation to undertake an investigation. In August of 1977, the Calspan Corporation issued its report, which revealed the presence of waste in the sewer and sump water near the Love Canal area and suggested that chemicals were migrating from the site. The report concluded that further study would be appropriate and recommended to the City of Niagara Falls that certain corrective

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91 Id.
92 Id.
93 In re Occidental, supra note 87. In anticipation of legal proceedings, this case ended with an Offer of Settlement submitted by Occidental to the SEC.
94 See id. at 83,351.
measures and monitoring activities be undertaken.\textsuperscript{95} The EPA and the Department of Justice did not bring suit seeking security for remedial action at the site until 1979. A suit by the State of New York followed in 1980. Nevertheless, the SEC ruled that “[b]y 1977, as a result of Hooker’s prior ownership and use of the Love Canal site and problems relating thereto, Oxy was potentially exposed to substantial financial risk” which should have been disclosed in the company’s annual report on Form 10-K for the fiscal year ending December 31, 1977.\textsuperscript{96}

(b) \textit{Hyde Park Landfill}: Hooker used this landfill from 1953 to 1974 as a waste disposal site. The New York State Department of Environmental Conservation (“NYSDEC”) had undertaken an investigation of the site which revealed chemical residue in the sediment north of the Hyde Park Landfill. NYSDEC had instructed Hooker to bring the site into compliance with applicable law by April 21, 1977. Hooker then spent $500,000 for closure of the site in August of 1977. Environmental issues continued to be identified, however, including trace amounts of waste in the bottom of a creek into which the site drained, groundwater contamination and migration of waste to soils outside the area. In January 1979, the Town of Niagara filed suit against Hooker claiming civil and punitive damages and requesting injunctive relief requiring the removal of the Hyde Park landfill and permit cancellation. While Oxy disclosed in its 1978 annual report on Form 10-K that “Hooker anticipated that civil lawsuits for personal injury and property damage would be commenced against Hooker arising from Hyde Park disposal seeking at least $3.8 million,” the SEC found that there should have been but there was no disclosure of potential financial exposure of Oxy for damages relating to the Hyde Park site in Oxy’s prior SEC filings.\textsuperscript{97}

(c) \textit{S-Area Landfill}: Hooker disposed of wastes at the S-Area Landfill from 1947 until 1967, and subsequently (until 1975) used the site for equipment washing. Wastes had been and were still believed to be leaching into and migrating from the Niagara River, presenting the possibility of contaminating the City of Niagara Falls municipal water treatment plant located 200 yards east of the Hooker Niagara plant. In September 1976, a joint EPA/NYSDEC/Hooker sampling program of all Niagara plant wastewater discharge was undertaken to determine the source of chemical contamination of Lake Ontario (85\% of the inflow of which lake comes from the Niagara River). Contemporaneously, the NYSDEC prohibited the possession and consumption of certain fish caught in Lake Ontario (until March 31, 1978). The SEC noted that, although wastes from the landfill had been contaminating, and were believed to be continuing to contaminate, the Niagara River and threatened to contaminate the adjacent Niagara

\textsuperscript{95} See \textit{id.} at 83,352.

\textsuperscript{96} \textit{id.} (emphasis added).

\textsuperscript{97} \textit{id.} at 83,353 (emphasis added). The SEC, however, acknowledged that Oxy’s third quarter report for 1978 on Form 10-Q did disclose that the cost of remedial action at Hooker’s waste disposal sites, other than Love Canal, “may be substantial.” See \textit{id.} at 83,353 n.22.
Falls municipal water treatment plant, Oxy should have disclosed its “potential liability” related to the S-Area Landfill.98

This proceeding against Oxy also raised the issue of the specificity with which companies must disclose their possible future environmental liabilities. The SEC indicated its unwillingness to accept general descriptions of possible future liability as sufficient disclosure. In its 1977 annual report, Oxy stated that “[i]n light of the expansion of corporate liability in the environmental area in recent years . . ., there can be no assurance that Occidental will not incur material liabilities in the future as a consequence of the impact of its operations upon the environment.”99 Thus Oxy did disclose the possibility of future environmental liabilities. The SEC found, however, that this general statement was not sufficiently detailed to inform the public about “potential liabilities . . . due to its discharge of substantial amounts of wastes” because Oxy did not “specifically disclose the amount, or describe the nature or extent, of [such] liabilities.”100

(iii) United States Steel Corporation. In an SEC enforcement action against United States Steel Corporation ("U.S. Steel") in 1979, the SEC asserted that U.S. Steel should have disclosed its environmental policy of “actively resisting environmental requirements which it maintained were unreasonable. The Company minimized and delayed capital expenditures for environmental control.”101 Instead of revealing this policy of noncompliance and the risks to which it would be subject as a consequence of that policy, U.S. Steel stated in its filings with the SEC that it “ha[d] pledged to confront and resolve its environmental problems as effectively and efficiently as technology, time and money permit.”102

The SEC has deliberately declined to impose an across-the-board requirement that all corporations disclose their general environmental policy since such requirement “would result in subjective disclosures largely incapable of verification.”103 Instead, the SEC has imposed only the following requirements:

First, if a corporation voluntarily chooses to make disclosures concerning its environmental policy, such disclosures must be accurate. And, the corporation must make any additional disclosures necessary to render the voluntary disclosure not misleading.

98 See id. at 83,353.
99 Id. at 83,351 (quoting Oxy’s Annual Report on Form 10-K for the period ending December 31, 1977).
100 Id.
101 In re U.S. Steel, supra note 6, at 82,380-1. In anticipation of legal proceedings, this case ended with an Offer of Settlement submitted by U.S. Steel to the SEC.
102 Id. at 82,381 (quoting U.S. Steel’s filings with the SEC).
Second, if a corporation has a policy or approach toward compliance with environmental regulations which is reasonably likely to result in substantial fines, penalties, or other significant effects on the corporation, it may be necessary for the [company] to disclose the likelihood and magnitude of such fines, penalties and other material effects in order to prevent from being misleading required disclosures with respect to such matters as descriptions or disclosures relating to description of the corporation’s business, financial statements, capital expenditures for environmental compliance or legal proceedings.104

2. Other SEC Enforcement Actions. In an SEC enforcement action against Lee Pharmaceuticals (“Lee”) in 1998, the SEC asserted that Lee and members of its board had violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.105 The SEC alleged that Lee had misrepresented and failed to adequately disclose its environmental liability in its periodic filings.

In 1987, Lee, a California manufacturer of dental and cosmetic products, learned of significant groundwater contamination at various of its facilities. In 1991, the State of California ordered Lee to remediate the contamination, but Lee refused to do so, citing financial difficulties. In the same year, the EPA designated Lee as a PRP for the neighboring San Gabriel Valley Superfund site. Lee indicated in its 1991 Annual Report on Form 10-K that its facility had some potential contamination, but did not disclose that it refused to remediate the site or that it had been designated a PRP at a nearby site.

Ultimately, the SEC determined Lee’s disclosure materially understated its liability, stating that:

Reasonable investors would consider it important that Lee had: (i) high levels of confirmed contamination originating on its property; (ii) continually failed to comply with governmental provisions regarding protection of the environment, such as performing its investigation and cleanup; (iii) been designated a PRP and had not been excused by the [US] EPA from clean-up obligations; and (iv) estimates ranging from $465,200 to $700,000 for Lee’s environmental investigation and cleanup costs, and of $30 million for the South El Monte portion of the San Gabriel Valley Superfund Site where Lee’s facilities were located. These facts would be important to investors because of the likelihood, under the circumstances, that Lee would be required to make material unrecoverable payments for both the Superfund site and its own property’s investigation and cleanup costs.106

104 Id. Although not technically required, some companies disclose their adherence to certain environmentally sound principles. In view of SEC requirements, issuers should avoid making positive statements in their disclosure. Issuers who do make such disclosure, however, should ensure the disclosure is accurate and contains all additional disclosures necessary to render it not misleading.


B. Case Law Regarding Environmental Disclosure

In the few cases that address environmental disclosure issues, the courts have shown some reluctance to support a broad reading of the disclosure requirements. For example, in In re Union Carbide Class Action Securities Litigation, the court found that Union Carbide had no duty to disclose the risks involved in its production of methyl isocyanate (MIC), which was the chemical released at Bhopal, India. The plaintiffs charged that the company’s failure to disclose this information violated the general antifraud provisions of the securities laws. According to the lower court, information about the risks of MIC was not material for purposes of the federal securities laws. The court asserted:

To require a corporation such as Union Carbide to include in its annual report the properties, production, risks and personnel requirements of MIC, as well as the other chemicals used and produced by the defendant, would overwhelm an investor with scientific and administrative facts “not conducive to informed decisionmaking.” Plaintiffs do not allege that the nature of Union Carbide’s business was concealed from them when they invested. It can come as no surprise to them that some of these chemicals are extremely hazardous and that an accident could have serious consequences.

The court stressed both that a materiality determination must be made from an ex ante, rather than an ex post, perspective, and that the law should not encourage companies to “bury the shareholder in an avalanche of trivial information.”

In Levine v. NL Industries, Inc., Levine, a shareholder of NL Industries, Inc. (“NL”) brought a class action suit on behalf of all NL shareholders claiming that NL had violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by its failure to disclose that its wholly owned subsidiary, NLO, Inc. (“NLO”), was operating a uranium processing facility (the “Fernald

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108 See id. at 1323. The plaintiffs charged violations of Sections 11 and 12(2) of the Securities Act and Rule 10b-5 under the Exchange Act.
109 See id. at 1327.
110 Id.
111 See id. (quoting Spielman v. General Host Corp., 402 F. Supp. 190, 194 (S.D.N.Y. 1975), aff’d per curiam, 538 F.2d 39 (2d Cir. 1976) (“[T]he determination of materiality is to be made upon all the facts as of the time of the transaction and not upon a 20-20 hindsight view long after the event.”)). See also Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 518 (7th Cir. 1989) (“The securities acts do not have this ex post perspective. Their approach is ex ante.”)
112 Union Carbide, 648 F. Supp. at 1327 (quoting TSC, Supra).
113 926 F.2d 199 (2d Cir. 1991).

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Facility”) for the United States Department of Energy (“DOE”) in violation of state and federal environmental laws.

The Second Circuit held that NL was not required to disclose that NLO was operating the Fernald Facility in violation of environmental laws on the ground that such disclosure was not material. The court stated that even if NLO were to have incurred some expenses in complying with environmental regulations, these expenses could not have had a material effect on the company because DOE was obligated to indemnify NLO for all expenses which NLO incurred in complying with environmental laws. The court asserted:

Under these circumstances, as the district court recognized, there was no plausible way that NL’s shareholders could suffer financially from the consequences of the alleged environmental violations. Accordingly, a reasonable investor would not consider NL’s asserted violations of environmental law important information significantly altering the total mix of information made available to the investor.\footnote{Id. at 203 (citations omitted).}

A corporation is not required to disclose a fact “merely because a reasonable investor would very much like to know that fact”.\footnote{In re Time Warner, Inc. Securities Litigation, 9 F.3d 259, 267 (2d Cir. 1993).} For example, in \textit{Gannon v. Continental Insurance Company}, a stockholder made several insurance claims against Continental, one of which concerned the company’s failure to disclose the reason it had not established a reserve for incurred but not reported [IBNR] asbestos related and other toxic tort claims.\footnote{920 F. Supp. 566 (D.N.J. 1996). The pertinent part of the 1993 annual report provides: “Continental does not establish reserves for unreported asbestos-related, other toxic-tort and environmental pollution claims because of significant uncertainties which do not allow liabilities to be reasonably estimated. Such uncertainties include difficulties in determining the frequency and severity of such potential claims and in predicting the outcome of judicial decisions, as case law evolves regarding liability exposure, insurance coverage and interpretation of policy language.” \textit{Id.} at 577.} The plaintiff sought monetary and equitable relief for alleged violations of Rule 10b-5.

Plaintiff Gannon alleged that Continental’s management failed to disclose in their 1993 annual report that they chose not to establish this reserve because management wanted to take their bonuses. While the court suggested that mismanagement problems may have plagued the corporation, it found that the company’s failure to disclose the reasoning behind its environmental reserve policy was not material. The court stated:

Continental Corp. never made any specific characterizations with respect to its reserve policy. The 1993 Annual Report merely stated that it was the corporation’s policy not to set aside reserves for Environmental IBNR losses. Since Continental Corp. did not comment on the quality of its reserve policy, but merely described what it was, the representation is not material.\footnote{Id. at 580.}
Thus, an environmental disclosure need not include the motivation behind a certain environmental policy so long as the policy is described accurately and includes all necessary additional information so that the description is not misleading.

Environmental disclosure cases, however, are often highly fact-specific and courts have found that seemingly innocuous language can form the basis for a cause of action. For example, in *In re AES Corporation Securities Litigation*, AES Corporation stated, in prospectuses, annual reports and public remarks, that AES had a commitment to integrity, fairness and social responsibility, at times pursued ethical values at the expense of profits, was a leader in the area of environmental compliance and had emission levels that were often below the levels required by its permits. After the public offerings were completed, AES disclosed that, unbeknownst to senior management, employees at one of the company’s facilities had been intentionally falsifying wastewater discharge reports so that it would appear that the plant was in compliance with relevant regulations. Plaintiffs filed a complaint alleging that AES’s previous public statements were materially false and misleading.

While the court noted that certain statements extolling AES’s environmental achievements were statements of opinion or belief and therefore could not form a basis for a Rule 10b-5 action, the court found that other statements, such as the following, were statements of fact, which generally are subject to Rule 10b-5:

> The company has been a leader in environmental matters associated with independent power production.

> The AES facilities have established high standards of operation. During 1990 and the first quarter of 1991, on average, these facilities have recorded emissions at levels considerably below those allowable under environmental permits, and have had a safety record better than the average for the electricity generating industry.

> AES monitors applicable environmental standards and evaluates the selection of technologies to ensure that the applicable standards will be met.

Plaintiffs alleged that the failure to disclose the intentional falsification of the reports by AES employees before, during and after the public offerings in question was a material omission. AES argued that at the relevant time only low level employees knew or should have known about the falsifications and that management therefore did not know and was not reckless in its ignorance of the falsifications. The court held that the allegations sufficiently established an inference of AES’s intent to defraud investors and that therefore the plaintiffs were entitled to discovery to ascertain whether additional facts existed which might

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119 Id. at 588-89.
prove that AES did intend to defraud investors in violation of Rule 10b-5.\footnote{Id. at 589. Under the current securities laws, as amended by the Sarbanes-Oxley Act, principal executive and financial officers are required to establish or cause to be established disclosure controls and procedures ensuring material information such as the falsification of environmental reports is made known to them. See Section III.A of this memorandum.} We do not have any information regarding the ultimate outcome of this matter.

V. **ENVIRONMENTAL DISCLOSURE IN FINANCIAL STATEMENTS**

Since 1975, the SEC, FASB and the AICPA have issued various standards and guidance documents regarding what are generally accepted accounting principles in the financial disclosure of, and accrual for, contingent environmental liabilities. Following is a brief summary of the most significant standards and statements. As further discussed in Section VI, the SEC has left no doubt that it intends to continue its emphasis on appropriate environmental financial disclosure, particularly accruals.

A. **Financial Accounting Standard No. 5 (FAS 5)**

In 1975, the FASB issued its Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (“FAS 5”)
\footnote{ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 1975) [hereinafter “FAS 5”].} \footnote{\textit{“Probable”} is defined as “likely to occur.” \textit{Id.} \S 3(a).} \footnote{The date of the financial statements is defined as “the end of the most recent accounting period for which financial statements are being presented.” \textit{Id.} \S 8 n.4. If information becomes available after the date of the financial statements but before those statements are issued, narrative disclosure may still be necessary to keep the financial statements from being misleading. \textit{Id.}.} \footnote{\textit{“Reasonably possible”} is defined as “more than remote but less than likely.” \textit{Id.} \S 3(b).} \footnote{\textit{Id.} \S 10.} requiring accrual of a contingent liability if (i) it is probable\footnote{Id. at 3.} \footnote{Id. ¶ 3(a).} \footnote{Id. ¶ 8 n.4.} that a liability has been incurred at the date of the financial statements in question\footnote{Id. ¶ 10.} \footnote{Id. at 589. Under the current securities laws, as amended by the Sarbanes-Oxley Act, principal executive and financial officers are required to establish or cause to be established disclosure controls and procedures ensuring material information such as the falsification of environmental reports is made known to them. See Section III.A of this memorandum.} \footnote{ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 1975) [hereinafter “FAS 5”].} \footnote{\textit{“Probable”} is defined as “likely to occur.” \textit{Id.} \S 3(a).} \footnote{The date of the financial statements is defined as “the end of the most recent accounting period for which financial statements are being presented.” \textit{Id.} \S 8 n.4. If information becomes available after the date of the financial statements but before those statements are issued, narrative disclosure may still be necessary to keep the financial statements from being misleading. \textit{Id.}.} \footnote{\textit{“Reasonably possible”} is defined as “more than remote but less than likely.” \textit{Id.} \S 3(b).} \footnote{\textit{Id.} \S 10.} and (ii) the amount of the loss can be reasonably estimated. In addition, narrative disclosure of the nature of the accrual, and in some cases the amount accrued, may be necessary for the financial statements not to be misleading. Even if no accrual is made because one or both of the above conditions are not met, narrative disclosure is necessary “when there is at least a reasonable possibility\footnote{Id. ¶ 10.} that a loss . . . may have been incurred.”\footnote{Id. ¶ 10.} Such disclosure should (a) indicate the nature of the contingency and (b) give an estimate of the possible loss or range of loss or disclose that such an estimate cannot be made. In addition, narrative disclosure may be necessary if an exposure to loss exists in excess of the amount accrued.

B. **FASB Interpretation No. 14 (FIN 14)**

From an environmental standpoint, one of the most frequently asked questions after the issuance of FAS 5 was whether a liability was reasonably estimable when a range of losses could be estimated but no single amount was a

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better estimate than any other amount within the range. In 1976, the FASB issued FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, (“FIN 14”)\(^{126}\) which stated that if some amount in the range is a better estimate than any other amount, that amount shall be accrued. However, “[w]hen no amount within the range is a better estimate than any other amount . . . the minimum amount in the range shall be accrued.”\(^{127}\) Thus, companies were encouraged to accrue an amount at least equal to the bottom number of the range.

\(\text{C. }\) FASB Emerging Issues Task Force, Issue No. 93-5

Even after issuance of FIN 14, a number of issues remained unresolved. For example, the SEC became aware that many companies were reducing the liabilities recorded on the books by taking into account anticipated recoveries from third parties (a practice known as “netting”) or by recording amounts discounted for the time value of money. The SEC became concerned that these practices were leading to a significant undervaluation of environmental liabilities in financial statements. In response to this concern, FASB’s Emerging Issues Task Force (“EITF”) issued a consensus position noting that an environmental liability should always be evaluated independently from any potential claim for recovery and that the loss arising from the recognition of an environmental liability should be reduced “only when a claim for recovery is probable of realization.”\(^{128}\) Thus, analyses for losses and recoveries are independent of one another and each must be “probable.” The EITF further stated that discounting environmental liabilities (i.e., recording only the present value of the estimated costs) is allowed only if the aggregate amount of the obligation and the amount and timing of the payments for the site are fixed or reliably determinable.\(^{129}\) The EITF’s positions have now been “incorporated in and effectively nullified by SOP 96-1” which is described below.\(^{130}\)

\(\text{D. }\) Staff Accounting Bulletin No. 92 (SAB 92)

The SEC issued SAB 92 in June of 1993. While most of the discussion in the bulletin can be characterized as a restatement of the existing standards described above, SAB 92 attempted to describe some of the issues in a more detailed and comprehensible manner and, in addition, made one extremely important clarification. Specifically, the SEC noted that it is not ordinarily appropriate to offset a contingent liability against a related claim for recovery, even if the claim for recovery is probable of realization. This means that all otherwise

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\(^{127}\) Id. ¶ 3.

\(^{128}\) Accounting for Environmental Liabilities, Issue No. 93-5 (Emerging Issues Task Force, Financial Accounting Standards Bd. 1993) (emphasis added). SAB 92, however, generally prohibits netting even if a claim for recovery is probable of realization. See Section V.D of this memorandum.

\(^{129}\) Accounting for Environmental Liabilities, supra note 128.

\(^{130}\) Accounting for Environmental Liabilities, supra note 128, pg 1.
recordable liabilities must be recorded on a gross basis, with a corresponding asset being recorded if, for instance, an insurance, indemnity or similar claim is probable of realization. While the SEC agreed that potential sources of recovery may be factored into the determination of whether there is a material event that is reasonably likely to occur, the SEC concluded “that separate presentation of the gross liability and related claim for recovery in the balance sheet most fairly presents the potential consequences of the contingent claim on the company’s resources.”

In addition, SAB 92 in some cases requires registrants to discuss, in the footnotes to the financial statements, uncertainties relating to the recorded liability. Uncertainties might include such items as the potential insolvency of another liable party, a dispute by another liable party as to its responsibility, or the fact that an additional loss at a site for which some liability has been recorded is, while perhaps not probable, nonetheless reasonably possible.

Similar footnote disclosure should be made with respect to uncertainties relating to receipt of insurance or indemnity proceeds. Finally, footnote disclosure may be required simply to permit the reader to clearly understand the nature of the liability, any relevant circumstances affecting the reliability and precision of cost estimates, cost-sharing arrangements with other PRPs and the time frame over which accrued or presently unrecognized amounts may be paid.

In determining how to quantify an environmental liability for purposes of complying with the accounting rules, SAB 92 instructs the registrant to look to the following sources of information:

(i) currently available facts relating to the registrant’s prior experience in remediation, other companies’ clean-up experiences and data released by the EPA or other organizations;

(ii) existing technology;

(iii) presently enacted laws and regulations; and

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131 SAB 92, supra note 8, at 32,844. In addition, FASB Interpretation No. 39 indicated that offsetting is improper except where a “right of setoff exists,” which right must be enforceable at law. OFFSETTING OF AMOUNTS RELATED TO CERTAIN CONTRACTS, Interpretation No. 39, ¶ 5 (Financial Accounting Standards Bd. 1992). This would generally preclude setoff in the typical environmental scenario, where recovery might be anticipated from an insurance carrier or other third party.

132 SAB 92, supra note 8 at 32,845. In addition, the disclosure in the footnotes to the financial statements should mesh with the disclosure provided pursuant to Item 303 of Regulation S-K. This point was specifically raised by former SEC Commissioner Roberts in 1994: “[If] the notes to the financial statements disclose the registrant’s expectations that insurers will indemnify a substantial portion of the expected costs to remediate a specific site, MD&A should discuss the related liquidity aspects, including when costs will be expended and when the insurance proceeds will be received.” Richard Y. Roberts & Kurt R. Hohl, Environmental Liability Disclosure and Staff Accounting Bulletin No. 92, 50 BUS. LAW. 1, 16 (1994).
(iv) the likely effects of inflation and other societal and economic factors.  

The SEC acknowledges that a registrant is permitted to record only its share of total costs so long as there is a “reasonable basis for apportionment of costs”. If, however, it is probable that another PRP will not fully pay its share of the costs, the registrant must also record its own estimate of additional costs it would be required to pay as a result of the failure of such other PRP to pay.

Finally, SAB 92 reiterates the position of FIN 14, discussed above, as to the timing of recognition of a liability. If a registrant can estimate a cost, that cost should be recorded. If a registrant does not believe it can estimate the specific cost, but it can determine a range of liability, then SAB 92 requires the registrant to recognize the minimum amount of the range if no amount within the range can be determined to be the better estimate. The Interpretive Response to Question 3 of SAB 92 makes clear that simply concluding that no estimate can be made because the remediation effort is in an early stage may not be sufficient:

Information necessary to support a reasonable estimate or range of loss may be available prior to the performance of any detailed remediation study. Even in situations in which the registrant has not determined the specific strategy for remediation, estimates of the costs associated with the various alternative remediation strategies considered for a site may be available or reasonably estimable. While the range of costs associated with the alternatives may be broad, the minimum clean-up cost is unlikely to be zero.

In February 2003, the SEC issued a summary finding many companies have failed to adequately disclose their environmental liability accruals, in particular those required by SAB 92.

E. AICPA Statement of Position 96-1

The Accounting Standards Executive Committee of the AICPA issued Statement of Position 96-1, Environmental Remediation Liabilities (“SOP 96-1”), in 1996. SOP 96-1 provides accounting guidance for the recognition, measurement and disclosure of environmental pollution control liabilities. It was issued in response to concerns that a significant number of companies were failing to accrue for known environmental remediation liabilities. While SOP 96-1

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133 SAB 92, supra note 8, at 32,844.
134 Id.
135 Id.
136 See Section VI infra, for more information.
137 ENVIRONMENTAL REMEDIATION LIABILITIES, Statement of Position 96-1 (American Inst. of Certified Pub. Accountants 1996). SOP 96-1 does not apply to compliance costs, voluntary remediation costs, or costs to restore or close sites upon the cessation of operations thereon or sale thereof.
primarily restates rules and concepts set forth in preceding bulletins and standards, it provides additional helpful guidance. In particular, SOP 96-1 provides a list of “recognition benchmarks” for certain types of remediation liability under the U.S. Superfund law, at which times the estimate of such remediation liability should be reevaluated. These benchmarks include:

(i) identification and verification of an entity as a potentially responsible party;
(ii) receipt of unilateral administrative orders;
(iii) completion of a feasibility study; and
(iv) issuance of a record of decision.\(^\text{138}\)

In addition, SOP 96-1 specifies that companies measuring environmental remediation costs shall include not only the “[i]ncremental direct costs of the remediation effort”, but also the cost to compensate those employees expected to devote “a significant amount of time directly on the remediation effort”.\(^\text{139}\)

\section*{F. \textit{Staff Accounting Bulletin No. 99}}

SAB 99 (“SAB 99”) was issued in August of 1999 to fulfill the SEC’s promise to clarify its views on evaluating the materiality of misstatements that companies and their auditors may identify in the preparation, and auditing, of financial statements. The SEC, through SAB 99, underscores the dangers companies may face if they rely only on quantitative benchmarks to determine whether an item is material. According to the Staff, “an assessment of materiality requires that one view the facts in the context of the ‘surrounding circumstances,’ as the accounting literature puts it, or the ‘total mix’ of information, in the words of the Supreme Court”.\(^\text{140}\) To help a company do that, SAB 99 sets forth a non-exhaustive list of key factors a company should consider when assessing the materiality of a misstatement, including:

(i) does a quantitatively small misstatement arise from an item capable of precise measurement or does it arise from an estimate and, if so, what is the degree of imprecision inherent in the estimate?

(ii) does the misstatement concern a segment (or other portion) of the registrant’s business that has been identified as playing a significant role in the registrant’s operations or profitability?

\(^\text{138}\) \textit{Id.} at chs. 5.15-5.16.

\(^\text{139}\) \textit{Id.} at ch. 6.5.

\(^\text{140}\) SAB 99 cites the Supreme Court’s holding in TSC, \textit{supra}, that a fact is material if there is “a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”
(iii) does the misstatement affect the registrant’s compliance with regulatory requirements?\textsuperscript{141}

SAB 99 applies to all aspects of preparing and auditing financial statements, including the accrual of environmental liabilities and the estimation of environmental capital expenditures and operating expenses.

VI. RECENT STUDIES AND PROPOSALS REGARDING ENVIRONMENTAL DISCLOSURE

The EPA issued an enforcement alert in October 2001 stating its intent to notify companies that are party to EPA enforcement actions of their potential duty to disclose these proceedings in their SEC filings.\textsuperscript{142} The alert was based on a 1998 EPA study that found that companies disclosed accurately only 16% of environmental governmental proceedings involving potential penalties in excess of $100,000.\textsuperscript{143} The alert was also based on a survey by Price Waterhouse (now PricewaterhouseCoopers) of SEC registrants in 1992 which indicated that 62% of the respondents had failed to accrue properly for environmental liabilities.\textsuperscript{144} The EPA stated in the 2001 alert that it “intend[ed] to monitor the disclosures made by parties to its enforcement actions and [would] share this information with the SEC.”\textsuperscript{145}

In 2001, the ASTM International published two standards for disclosing and estimating environmental liabilities and costs.\textsuperscript{146} The first, ASTM Standard E 2137-01 for Estimating Monetary Costs and Liabilities for Environmental Matters (“ASTM E 2137”), sets forth non-binding standards by which companies may estimate their environmental liabilities. Companies may use these standards for various purposes, including in preparing SEC disclosure and in analyzing

\textsuperscript{141} SAB 99, supra note 4.


\textsuperscript{143} This study was conducted by Abt Associates Inc., Cambridge, Massachusetts, under contract #68-W98-005, WA 1-07 and WA 2-07.


\textsuperscript{145} Enforcement Alert, supra note 142. The EPA and the SEC have had in place an informal agreement to share information since at least 1990. Pursuant to this arrangement, (a) EPA was to provide training to SEC staff to spot inconsistencies in public filings and provide information about public companies, including lists of potentially responsible parties for Superfund sites and (b) the SEC was to provide EPA with financial information on companies the agency has targeted for enforcement action. This informal arrangement has not been actively implemented for many years, according to the 2004 GAO Report discussed later in this section.

acquisition, divestiture and other business transactions and lawsuits. ASTM E 2137 identifies the type of information companies should consider in developing cost estimates, such as (i) the number of affected facilities, (ii) the type and extent of contamination, (iii) available technology, (iv) relevant law, (v) the use of the subject sites, (vi) the extent of public participation, (vii) whether any related claims or litigation are pending or threatened and (viii) the company’s prior experience with similar liabilities. In contrast to the current accounting standards and guidance which permit companies to accrue the minimum expected costs of a liability, ASTM E 2137 provides that companies should accrue an amount equal to the expected value of the liability. If the company cannot determine the expected value, it should accrue the most likely value and a range of possible costs. If the company cannot determine the most likely value and range of costs, it must accrue the known minimum costs and provide sufficient qualitative disclosure to inform investors of the uncertainties that prevent it from disclosing a more precise cost estimate.

The second standard, ASTM Standard E 2173-01 for Disclosure of Environmental Liabilities (“ASTM E 2173”), provides guidance in drafting environmental narrative disclosure in financial statements and in the MD&A section. The standard assists companies in determining (i) what environmental liabilities are material, (ii) what types of circumstances might give rise to an environmental liability and (iii) what statements a company should include in its disclosure. ASTM E 2173 recommends that companies disclose (a) statements regarding the number of sites for which the entity has been named a PRP and the number of claims that have been presented to the reporting entity for payment; (b) the company’s estimate of environmental liabilities; (c) a description of the approach used to estimate them; (d) the amounts accrued for them; and (e) a description of key external and internal environmental factors regarding the timing or amount of liabilities or recoveries. If a company cannot quantify a material liability, it must include a written statement describing the conditions or problems associated with making that estimate.

In September 2002, the Rose Foundation for Communities and the Environment, a not-for-profit organization, petitioned the SEC to promulgate rules making ASTM E 2173 and E 2137 binding on reporting companies. Over forty other entities, including various mutual funds, brokers, labor organizations, non-governmental organizations and other foundations, have petitioned the SEC in support of this request for rulemaking. There is no indication from the SEC that they are interested in adopting these standards.

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147 E 2137-01, §5.1.2.
148 E 2137-01, § 5.2.
149 E 2173-01, § 6.2.2
In February 2003, the SEC’s Division of Corporate Finance issued a summary of “Significant Issues Addressed in the Review of Periodic Reports of the Fortune 500 Companies”. The division found many companies had failed to disclose in their periodic reports for calendar year 2001 environmental liability accruals and, in particular, those required by SAB 92. In its summary, the division “urged companies with material contingent [environmental and product] liabilities to carefully review their disclosures and ensure they include all required information” and to provide in their MD&A sections a “meaningful analysis as to why amounts charged in each period were recorded and how the amounts were determined.”

Finally, on July 15, 2004 the GAO submitted the 2004 GAO Report. The 2004 GAO Report was requested by members of Congress to determine (i) stakeholders’s views on how well the SEC has defined the requirements for environmental disclosure, (ii) the extent to which companies are disclosing environmental information in their filings with the SEC, (iii) the adequacy of the SEC’s efforts to monitor and enforce compliance with the disclosure requirements and (iv) what actions experts suggest for increasing and improving environmental disclosure.

The GAO Report focused largely on the overall inadequacy of the SEC’s information regarding the extent and accuracy of companies’ environmental disclosures due to its limited access to company records and an absence of a database to track SEC comments and their responses. The report also described the diametrically opposing stakeholder views regarding SEC requirements for environmental disclosure: investor organizations and researchers often believe the current requirements are insufficient, ignored, or inadequately enforced, while public companies and their advisors generally feel that the current requirements are adequate and any apparent failures to comply with the requirements are due to the variability in companies’ circumstances rather than a failure to comply with the existing rules.

The GAO provided three concrete recommendations: (i) the SEC should electronically store, track and analyze its review of company filings; (ii) the SEC should investigate the creation of a publicly accessible database of SEC comment letters and company responses; and (iii) the SEC should establish a closer relationship with the EPA. According to the 2004 GAO Report, the SEC “agreed with the report’s recommendations and is taking some actions to implement

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151 See the “Environmental and Product Liability Disclosures” section of the SEC summary, which is available at www.sec.gov/divisions/corfin/fortune500rep.htm.

152 Id. SEC Commissioner Harvey Goldschmidt cited this study in a July 2003 Capital Hill symposium organized by the Corporate Sunshine Working Group and attended by various environmental and public interest groups and members of Congress.

153 This recommendation has already been implemented on a broader basis. On June 24, 2004, several weeks before the 2004 GAO Report had been issued, the SEC announced it would provide, free of charge through the SEC’s Public Dissemination Service and on its website, all comment letters and response letters relating to disclosure filings made after August 1, 2004.
them”. It may be quite some time before any substantive decisions are made by the SEC as to whether, and if so what, changes are necessary in the area of disclosure of environmental liabilities.

VII. SOME PRACTICAL CONSIDERATIONS

The SEC has made clear that a reporting company’s environmental disclosure must be correct and adequate, and that a company’s failure to maintain adequate disclosure controls and procedures is a securities law violation.

Generally, if the appropriate individuals have the necessary information, disclosure is more likely to be adequate. Specifically, it may be appropriate for reporting companies to do some or all of the following:

- Charge a group of employees and/or officers (“responsible corporate individuals”) with the responsibility for both environmental disclosure and disclosure controls.

- Communicate to the rest of the company that all environmental data and other communications must be filtered through these responsible corporate individuals.

- Ensure the responsible corporate individuals are:
  - asking the environmental personnel at each facility all appropriate questions to determine if there are any matters, information, trends, transactions and/or liabilities in the nature of those listed in the “Introduction -- Executive Summary” above which would need to be disclosed;
  - drafting and updating disclosure, both on a factual and legal compliance level;
  - ensuring that the disclosure, financial statements and information presented to the SEC, EPA and other environmental agencies are consistent;
  - setting the tone within the company that compliance with disclosure requirements is a priority; and
  - periodically evaluating the company’s procedures for sufficiency or for areas of improvement.

- Provide the responsible corporate individuals and, if necessary, the environmental personnel at the company’s facilities, with access to attorneys and accountants to the extent needed.

VIII. CONCLUSION

Public companies have always been required to provide disclosure about material environmental costs and potential material environmental risks. The environmental disclosure rules those companies must follow are complicated and practical questions arise regularly. In addition, recent corporate scandals and general concerns about the disclosure of public companies have increased the scrutiny of all public company disclosure, which will lead to even more complicated analyses and questions.

In order for any company to ensure that it is complying with all of the rules and meeting the needs of its constituencies, a company must have a clear and rational basis for how it discloses environmental matters, and in particular, for any decisions it makes to not disclose particular environmental matters or risks. This should all be done in a manner that meets the technical rules set forth by the SEC and in various accounting standards as described in this memorandum, but it should also be done in a manner that meets more general SEC mandates to provide disclosure that is both useful and understandable and that is not overly general.

To meet all of these goals, a public company should review, on a regular basis, the SEC and accounting disclosure requirements set forth in this memorandum, should have systems in place that permit the appropriate senior managers to be fully aware of all material environmental risks, and should review any environmental disclosure decisions, and the disclosure itself, on a regular basis.

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