
Remarks Of

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# "Recent Developments Concerning Environmental Disclosure"

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Dallas, TX
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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

U.S. Securities and Exchange Commission
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# RECENT DEVELOPMENTS CONCERNING ENVIRONMENTAL DISCLOSURE

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## I. INTRODUCTION

The importance of environmental disclosure is reflected in the offering documents and periodic reports filed with the Commission every day by issuers located throughout the country. I intend today to provide a brief overview of the environmental disclosure requirements applicable to issuers under our federal securities laws and to provide an update on some recent items of interest in the environmental disclosure area.

## II. OVERVIEW

As society strives to maintain and to improve our environment, costs are imposed that may need to be disclosed to investors under our federal securities laws. Compliance costs associated with regulations restricting development and limiting harmful emissions can have a material effect on the operating expenses of a company. Moreover, environmental laws can impose large

liabilities, particularly with respect to past generators of waste materials. Indeed, the term "environmental due diligence" has acquired a relevance to participants in business transactions that would have been unimagined only a decade ago.

Particular industries, such as the pharmaceutical, petroleum, chemical, waste management, and heavy manufacturing segments, among others, must be particularly sensitive to disclosure and accounting issues presented by these laws. A study recently conducted by researchers at the University of Tennessee's Waste Management Research and Education Institute ("Tennessee Study") apparently estimates that cleanup of the nation's known hazardous waste sites will cost $752 billion over 30 years under current environmental policies.[1] More particularly, the Tennessee Study estimates that the cleanup job at still operational hazardous waste sites regulated under the Resource Conservation and Recovery Act ("RCRA") may cost $234 billion over the next 30 years. Similarly,

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[1] See Lavelle, SuperFund Studies Begin to Fill Hole In Data-Dry Field, National Law Journal (January 20, 1992) at 19.

the Clean Water Act and the Clean Air Act each impose annual compliance costs estimated by the EPA at more than $30 billion.

At this point, I wish to diverge somewhat and to focus briefly on the issue of Clean Air Act compliance costs. A common question asked by issuers is how companies can make compliance cost estimates when the regulations to be promulgated pursuant to the Clean Air Act Amendments of 1990 ("Amendments") have not yet been issued. The Amendments require certain emissions to be reduced to specified levels or to be completely phased-out over specified time periods and also require companies within particular industries to install the best available technology to reduce pollution. According to representations from the EPA staff to Commission staff, companies are aware of the best technology, including its cost. Moreover, the EPA apparently has estimated the cost of compliance with the Amendments for each major industry. Therefore, it appears that the EPA staff is of the opinion that companies are presently able to estimate, at least on a worst case basis, the cost of complying with the Amendments, except in one

instance. With respect to air toxic pollutants, it is my understanding that the timing, but not the magnitude, of costs may be uncertain until the relevant regulations are in fact issued.

Much of the recent environmental disclosure debate has focused on issuer liability under the Comprehensive Environmental Response, Compensation and Liability Act, known as the "SuperFund" legislation or "CERCLA." Under this legislation, waste transporters and waste generators, as well as past and present owners and operators of hazardous waste sites, may be designated by the EPA as Potential Responsible Parties ("PRP"). Unlike most fault-based liability schemes, past or present owners of a hazardous waste site can be held liable without regard to whether they were responsible for the release of hazardous substances. Moreover, each PRP is "jointly and severally liable" for the cost of cleaning up the entire site. The expanding scope of environmental liability under the SuperFund legislation has produced a perhaps unanticipated effect on lenders that, through foreclosure, acquire title to a hazardous waste site. However, it is my understanding

that this lender liability problem has been minimized by a recent EPA ruling that limits bank liability under CERCLA.

Currently, there are some 1200 sites designated on the SuperFund national priorities list. Several of these sites are located in Texas, including some of the largest. Another 12,800 sites nationally have been submitted as candidates for the list. Cleanup costs at the average SuperFund site are estimated by the EPA to be approximately $25 - $30 million. The Tennessee Study estimates that the cleanup of SuperFund sites nationally will be a probable 30-year cost of $151 billion.

The potential for large losses attributable to environmental problems is an important concern that many investors will factor into their investment decision. One need only look at the newspaper in recent weeks to learn of growing environmental problems which pose substantial potential environmental liabilities. Recently, for example, the press has reported extensively on the potential liability arising from possible leaks from the thousands of

underground storage tanks located in the greater Washington area.[2] The Tennessee Study estimates the cleanup effort of the underground storage tank problem to cost nationally as much as $67 billion. Indeed, vigorous enforcement of environmental laws likely to occur in the decade to come have made environmental liability a matter of growing prominence for lenders, rating agencies, and acquisition-minded companies, among others.

## III. PRINCIPAL REPORTING REQUIREMENTS

### A. Historical Role of the Commission

As you are aware, the federal securities laws are designed to promote full disclosure of material facts. The general antifraud provisions impose liability on persons who make false statements or omissions of material facts in connection with the purchase or sale of securities. In certain cases, these general antifraud provisions will require disclosure to investors of the material effect of environmental laws on an issuer.

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[2] "Tank Leaks Pose Risks, Raise Costs," The Washington Post, May 10, 1992 at A1.

In addition to complying with the general antifraud provisions of the federal securities laws, issuers registering public offerings of securities under the Securities Act of 1933, or filing periodic reports under the Securities Exchange Act of 1934, must comply with the applicable line-item disclosure requirements under Regulation S-K. With the increase in regulation and environmental liability since the early 1970s, the Commission has attempted to refine through interpretive releases the disclosure obligations raised by environmental legislation, and the regulations promulgated thereunder.[3] In addition, several past prominent enforcement actions instituted by the Commission against issuers that failed to disclose known environmental liabilities and compliance costs have highlighted the importance of accurate disclosure in this area.[4]

B. Regulation S-K

Three provisions of Regulation S-K have particular significance for issuers that are subject to potential environmental liabilities and

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[3] See, e.g., Securities Act Release No. 5170 (July 19, 1971).

[4] See, e.g., In the matter of United States Steel Corporation, Securities Exchange Act Release No. 16223 (Sept. 22, 1979).

risks. It is my understanding that proposed Regulation S-B, which would apply to small business issuers, incorporates these three provisions of Regulation S-K without substantive change.

1. Item 101 - Description of Business

Item 101 of Regulation S-K, for example, requires an issuer to provide a general description of its business. In addition, it requires specific disclosure of the material effects that compliance with federal, state and local environmental laws may have upon the capital expenditures, earnings, and competitive position of the issuer.

2. Item 103 - Legal Proceedings

Item 103 of Regulation S-K, for another example, requires that the issuer disclose any material pending legal proceeding, including specified proceedings arising under federal or state environmental laws. It is important to note that any such proceedings known to be contemplated by governmental authorities are required to be disclosed.

### 3. Item 303 - Management Discussion and Analysis

Finally, the Management Discussion and Analysis ("MD&A") provision of Regulation S-K, Item 303, requires management to discuss the issuer's historical results and its future prospects. As set forth in a 1989 Commission interpretive release, this forward-looking disclosure is triggered by any "known" trends, demands, commitments, events or uncertainties that are reasonably likely to have a material effect on the issuer's operating results or financial condition.[5] The purpose of the MD&A is to give investors a look at the company through the eyes of management. MD&A and the related financial statements are the heart of an issuer's disclosure document. Obviously, Item 303 would compel management to disclose the significant implications of environmental laws on future operations of the issuer.

The recent Commission MD&A enforcement case against Caterpillar should make it perfectly clear, if it was not already, that

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[5] Securities Act Release No. 6835 (May 18, 1989).

the Commission treats MD&A disclosure very seriously.[6] I would not be surprised if an MD&A environmental related enforcement case materialized in the near future.

It has come to my attention that many issuers have disclosed the fact that they have been named as a PRP for a SuperFund site but have stated that they are unable to determine whether the potential liability has a material effect on their financial condition or results of operations. The explanation given for this conclusion is that the issuer is unable to determine whether it is probable that a liability has been incurred and is thus unable to determine a reasonable estimate for the amount of the loss. There is a concern that once this conclusion is reached and disclosed, it becomes boilerplate that will appear in all periodic reports thereafter. Such a conclusion logically cannot exist indefinitely. At some point the information improves, and a judgment on materiality should become clearer. It is my understanding that the Division of Corporation Finance is presently comparing Forms 10-K from one year to

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[6] In the Matter of Caterpillar Inc., Securities Exchange Act Release No. 30532 (March 31, 1992).

another to ensure that this uninformative disclosure is being updated or changed appropriately.

## IV. ACCOUNTING AND DISCLOSURE RELATING TO ENVIRONMENTAL LOSS CONTINGENCIES

Beyond the narrative discussions mandated by Regulation S-K, environmental matters also may have financial implications for issuers. Generally accepted accounting principles, specifically FASB Statement No. 5, entitled "Accounting for Contingencies," indicate that an estimated loss from a loss contingency must be accrued by a charge to income if it is probable that a liability has been incurred and that the amount of the loss can be reasonably estimated. I must say that it is my impression that accruals concerning environmental liability are not showing up in the financial statements as quickly as I believe that they should be.

It is the responsibility of management to accumulate on a timely basis sufficient relevant and reliable information to make a reasonable estimate of environmental liability. If management determines that the amount of the liability is likely to fall within a range and no amount within that range can be determined to be the

better estimate, the registrant is required to record the minimum amount of the range.[7] The additional exposure to loss should be disclosed in the footnotes to the financial statements if there is at least a reasonable possibility that a financial loss has been incurred. That disclosure should describe the environmental exposure, including an estimate, or range of estimates, of the loss (or if there is no reasonable estimate, it should so state). Changes in estimates of the liability should be reported in the periods that they occur.[8] The measurement of the liability should be based upon currently enacted environmental laws and upon existing technology. Issuers are not expected to be clairvoyant with respect to future technology.

The recognition and measurement of the liability must be evaluated separately from the consideration of any expected insurance recoveries. If information is available that a probable environmental liability has been incurred as of the date of the

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[7] FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.

[8] See APB Opinion No. 20.

financial statements, the amount of the issuer's liability should be recognized and recorded, if it can be estimated, regardless of whether the issuer is able to estimate the amount of recoveries from insurance carriers.[9]

In assessing the probability of an insurance recovery, issuers should consider the success of similar claims and the insurer's financial viability. It is only appropriate to reduce a probable liability with a probable insurance recovery, not a reasonably possible insurance recovery. It is my understanding that many issuers subject to potential SuperFund liability are stating in their disclosure documents that it is probable that insurance will cover all or most of the estimated potential environmental liability, while the pattern from the insurance industry side appears to be that the insurance companies are fighting like mad to fend off their responsibility to pay for the issuer's liability. Such a pattern is

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[9] In contrast, however, the FASB emerging issues task force has recently provided guidance indicating that the cost of improvements necessary to prevent further environmental contamination, or to comply with new regulations, may be capitalized and amortized over succeeding periods rather than expensed immediately. EITF Issue No. 90-9, Capitalization of Costs to Treat Environmental Contamination.

confirmed by the recent report issued by the Rand Corporation Institute for Civil Justice ("Rand Report").[10] Rand extrapolated from its data that the nation's insurance industry likely spent $410 million on SuperFund related legal fees in 1989, and only $60 million for hazardous waste cleanup. The money that the insurance industry spent on attorneys in 1989 amounted to almost 90% of the industry's total SuperFund spending. The Rand Report concluded that the current insurance focus was on questions involving coverage. Thus, the findings of the Rand Report suggest that some disclosures made by issuers concerning the probability of insurance recoveries for SuperFund liabilities are questionable. In my opinion, the Commission should scrutinize carefully the disclosures in this area.

Despite the growing importance of environmental issues, a recent survey by Price Waterhouse indicates that at the largest corporations, only 11% had adopted any written accounting procedures or policies to deal with environmental issues, and only

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[10] J. Acton & L. Dixon, SuperFund and Transaction Costs, The Experiences of Insurers and Very Large Industrial Firms (Rand 1992).

14% had established environmental oversight committees at the Board of Directors level.[11] Further, a majority of companies (68%) stated that they did not accrue currently for future environmental expenditures.

Identifying and interpreting environmental risks will continue to challenge the accounting industry. Accountants should increase their efforts to assess the proper financial statement presentation and disclosure of environmental contingencies. Hopefully, as the spotlight on environmental issues becomes more focused, as cleanup technology and equipment improve, and as estimating cleanup costs becomes easier, earlier recognition of liabilities in financial statements will result.

## V. ONGOING COMMISSION REVIEW

It is clear that aggressive enforcement of environmental laws will increase in the 1990s. "Environmental due diligence" is a phrase that will grow increasingly familiar to the attorneys that represent both public issuers and investors. At the Commission,

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[11] See Surma and Vondra, "Accounting for Environmental Costs: A Hazardous Subject," Journal of Accountancy (March 1992) at 51.

the large dollar amounts of anticipated SuperFund costs and RCRA costs have produced increased pressure to monitor the adequacy of issuer disclosure. During the past several years, the Commission's staff has been looking closely at the adequacy of environmental disclosure in connection with its review of filings; and I anticipate that such scrutiny will continue. When the staff finds material omissions or deficiencies relating to environmental matters, it will request corrective disclosure and, in egregious cases, may refer the matter to the Division of Enforcement.

In order to enhance the disclosure in this area, a dialogue has developed between the staffs of the Commission and the Environmental Protection Agency. Through an informal understanding, Commission staff receives from the EPA lists of all companies that have been named as PRPs on hazardous waste sites. Information also is received concerning companies subject to the cleanup requirements under RCRA, criminal cases under federal environmental laws, civil proceedings under environmental laws, and companies barred from government contracts under the Clean Air

Act and the Clean Water Act. Commission staff currently utilizes this information in its review process. In addition, Commission staff occasionally refers environmental disclosure issues to EPA staff for informational purposes and input.

## VI. CONCLUSION

In conclusion, many issuers already are acutely aware of their responsibilities and potential liability under our environmental laws. For example, the results of a recent survey conducted by the National Association of Corporate Directors of 4,600 of the nation's chief executive officers indicated that the CEOs surveyed appeared to be aware of and concerned about their companies' potential environmental liability.[12] Regardless of issuer sophistication, however, it is the responsibility of the lawyers in this audience to make sure that your clients are familiar with their responsibilities to investors under our federal securities laws.

I challenge each of you to acquaint yourselves with the environmental regulations and to focus seriously on whether your

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[12] "National Association of Corporate Directors Announces Finding From CEO Survey" (Feb. 10, 1992) (NACD News Release).

clients have adequately disclosed the short-term and long-term effects of environmental laws on their operations. To ensure continued proper disclosure, you should revisit your clients' disclosure from the prior filing and should determine whether recent events or estimates would require additions or modifications. Also, at a minimum, it appears to me that you should advise your issuer clients to establish policies requiring full compliance with all environmental laws and regulations, as well as requiring self-monitoring mechanisms to ensure that corporate officers and employees are faithfully complying with such policies.