Remarks Of

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Environmental Liability Disclosure Developments

The Association of the Bar
of the City of New York
New York, New York
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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.

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I. INTRODUCTION

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. These environmental costs have reached staggering proportions in recent years and are one of the critical issues facing businesses today. Compliance costs associated with regulations restricting development and limiting harmful emissions can and often do 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.

II. MAGNITUDE

It may be helpful to focus briefly on the magnitude of the costs involved. A study published last year which was conducted by researchers at the University of Tennessee's Waste Management Research and Education Institute ("Tennessee Study") 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, the Clean Water Act and the Clean Air Act each impose annual compliance costs estimated by the Environmental Protection Agency ("EPA") at more than $30 billion.

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1 See Lavell, "Superfund Studies Begin to Fill Hole in Data-Dry Field," National Law Journal (Jan. 20, 1992), at 19.

Further, the EPA estimates that there are between 2 and 3 million underground storage tanks in the United States storing petroleum and hazardous waste products.[2] Most were buried over 20 years ago and have no corrosion protection. The Tennessee Study estimates that the cleanup effort of the underground storage tank problem will cost nationally as much as $67 billion.

Much of the recent environmental disclosure debate has focused on issuer liability under the Comprehensive Environmental Response, Compensation and Liability Act, know as the "Superfund" legislation. 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 Potentially Responsible Parties ("PRPs"). Unlike most fault-based liability schemes, past or present owners of a hazardous waste site can be held liable under Superfund 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.

Currently, there are some 1200 sites designated on the Superfund national priorities list. 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. Apparently fewer than 50 sites have been remediated since the inception of Superfund in 1980.[3]

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2 See Adams, "Accounting for Environmental Costs: A Discussion of the Issues Facing Today's Business," AICPA Environmental Issues Roundtable (Jan. 7, 1993), at 5-6.

3 Id.

Ten years ago, 2% of capital spending was for environmental matters. Now it is estimated to be 20%. Annual environmental expenditures have also apparently grown from $26 billion in 1972 to $115 billion in 1990. In addition, it has been estimated that the undiscounted liabilities of U.S. insurers for cleanup costs, legal costs, third party damages, and natural resource costs, net of proceeds from foreign insurers and reinsurers, range from $37 billion to $426 billion.[4] Certainly one of the major threats to the solvency of the property and casualty insurance industry is the risk of contract reinterpretation that could impose enormous unforeseen environmental cleanup costs on the industry.

While the aggregate numbers concerning potential environmental costs are staggering, what is even more frightening is the massive amount of acknowledged environmental cost that has yet to be reflected in corporate financial statements. Despite the growing importance of environmental issues, a recent survey by Price Waterhouse indicates that 62% of the companies responding to the survey have known environmental liability exposures not yet recorded in their financial statements.[5] Thus, environmental liability, if not already, will soon become a prominent concern for many issuers, lenders, trustees, insurers, investors, underwriters, broker-dealers, rating agencies, attorneys, accountants, corporate officers, corporate board members, and acquisition-minded companies.

III. SUPERFUND DEVELOPMENTS

Since I have mentioned the subject of Superfund, there are some potential developments in the Superfund area that I wish to alert you to. First, of course, will be the

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4 Id.

5 "Accounting for Environmental Compliance: Crossroad of GAAP, Engineering, and Government," a survey of corporate America's accounting for environmental costs conducted by Price Waterhouse (1992, second in a series), at 1 ("Price Waterhouse Survey").

legislative reauthorization which should take place next year. There has already occurred a substantial amount of public discussion concerning potential changes in the current Superfund statutory scheme, and it will be interesting to observe the legislative path chosen.

Second, last April, the EPA issued a rule governing the liability of lenders under Superfund. The rule attempted to limit lender liability under certain circumstances. This rule is currently in litigation, and the litigation results may trigger additional rulemaking and/or legislation. There also exists sentiment to extend a similar rule to trustees.

Third, a struggle remains at the EPA, in the Congress, and in the courts over municipal liability under Superfund. The U.S. Court of Appeals for the Second Circuit ruled last March that a municipality may be liable under the Superfund program for cleanup costs at a privately owned landfill if the municipality's waste contained any amount of hazardous substances.[6]

Approximately 250 municipal landfills are designated on the Superfund national priorities list. It has been estimated that more than $6 billion will be needed to remediate those sites. Obviously, industrial owners and landfill owners are interested in pursuing massive contribution claims against local governments as a means of avoiding picking up this tab.

Recently, the EPA has apparently abandoned an initiative to resolve the cost allocation issues that are present at sites which contain non-hazardous municipal wastes and industrial hazardous wastes.[7] It appears that the EPA intends to handle municipal liability in this area on a case by case basis pending the reauthorization of Superfund.

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6 B.F. Goodrich Co. v. Murtha, No. 91-7450 (March 12, 1992).

7 "Program Officials Hail Site Completions, Outline Accelerated Cleanup Pilot Projects," BNA Environment Reporter (Nov. 6, 1992), Vol. 23, No. 27, at 1715.

The environmental liability developments in the lender, trustee, and municipality area bear watching since those developments may have a major impact on the evolution of the Superfund program as well as on the legislative reauthorization. The continuation of any selective liability narrowing trend should intensify the necessity for the public companies saddled with the Superfund cleanup costs to disclose to the fullest the most current information regarding the costs and reserves attendant to both existing and potential Superfund liabilities.

The final development that I wish to mention, although not totally related to Superfund, involves the shareholder proposal process. Concern about environmental issues is manifest in the shareholder proposals that corporations may be required to consider as they prepare for their annual meetings each year, particularly since the grounds for excluding such proposals sometimes change over time. Shareholder proposals often attempt to link environmental concerns with the economic well being of a corporation; and, if successful, such proposals may establish new directions for the corporation.

One such example was the D.C. Circuit Court of Appeals case of Roosevelt v. DuPont where a shareholder was partially successful in challenging a lower court decision allowing the exclusion of a proposal that would require DuPont to accelerate the phase out of chlorofluorcarbon ("CFC") production before 1995.[8] CFCs, as we all know, have been linked to the depletion of the ozone layer, and DuPont is the largest producer of CFCs in the world.

In any event, the recent development in the shareholder proposal environmental area that I wish to mention is the decision issued earlier this year by the U.S. Court of Appeals for the Second Circuit in United Paperworkers International Union v. International Paper

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8 **(D.C. Cir. 1992), 958 F. 2d 416.**

Co.[9] In this case, the appeals court affirmed a lower court decision that International Paper Company committed proxy rule violations by materially misrepresenting its environmental record in responding to a shareholder proposal urging adoption of the Valdez Principles. Further, the appeals court ruled that the company must disclose and describe the United Paperworkers decision in its 1993 proxy materials.

I anticipate that the combination of the Roosevelt and United Paperworkers decisions will cause issuers, if they did not already, to treat with the utmost care shareholder proposals in the environmental liability area and the issuer response thereto. I suspect that shareholder proposals on environmental responsibility will continue to increase.

IV. COMMISSION REVIEW DEVELOPMENTS

As everyone here is aware, the federal securities laws are designed to promote full disclosure of material facts. While there are those that advocate that the Commission should attempt to enforce the securities laws in a manner that effectively regulates corporate environmental conduct, I am more comfortable with the traditional Commission role of pressing for clear disclosure of all environmental information that is economically material to the issuer.[10]

At the Commission, the large dollar amounts of anticipated environmental liability costs have produced increased pressure to monitor the adequacy of issuer disclosure. During the past several years, the staff of the Commission's Division of Corporation Finance has been looking closely at the adequacy of environmental disclosure in connection with its review of filings. I expect this scrutiny to continue generally and even to become more intense with respect to issuers that are in industries which are significantly effected by

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9 Fed. Sec. L. Rep. (CCH) ¶97,342 (Feb. 12, 1993).

10 See Ferman, "Environmental Disclosure and SEC Reporting Requirements," 17 Delaware Journal of Corporate Law 483 (1992).

environmental risks such as pulp and paper companies, primary metal manufacturers, and industrial organic chemical manufacturers, among others. When the staff finds material omissions or deficiencies relating to environmental matters, it will continue to request corrective disclosure and, in egregious cases, may refer the matter to the Division of Enforcement.

In order to enhance the disclosure in the environmental liability area, a dialogue has been developed between the staffs of the Commission and the EPA. The Commission now utilizes EPA staff to help train Commission staff in the environmental liability disclosure review area. Further, 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 the past, Commission staff has considered formalizing this dialogue through the execution of a memorandum of understanding with the EPA. Given the "change" that has occurred in the leadership of the EPA and that will occur soon in the leadership of the Commission, I hope that the pursuit of such an agreement is renewed. I believe that a formal memorandum of understanding could be beneficial to both agencies in fulfilling their statutory responsibilities.

In the filing review area, Commission staff is also closely scrutinizing the potential impact of environmental liabilities on the insurance industry. In a letter last year in response to an inquiry from Chairman Dingell and Congressman Wyden concerning amounts paid by insurance companies for Superfund cleanup costs, the General Accounting Office ("GAO") concluded that data obtained from fifteen of the top 20 property and casualty insurers revealed that about $155 million was paid during the period 1982 to 1991.[11] The fifteen insurance companies reporting underwrote approximately 55 percent of the general liability market in 1990. Among the survey limitations, GAO did not consider transaction costs associated with these claims.

In this regard, it is significant to note that the GAO survey found that the bulk of the cleanup cost payments (i.e., $144 million) occurred in ever increasing amounts over the period 1987 through 1991. For example, cleanup cost payments increased from $9.3 million in 1987, according to GAO, to $55 million in 1991. If these payments continue to increase in such a rapid fashion, they will eventually have a material impact on some insurer operations.

I noticed already that one large insurer, in its most recent fourth quarter results, included a $180 million charge for reserve additions for certain asbestos and environmental exposures. This same insurer has increased its reserve addition for environmental liability claims from $8 million at year end 1990 to $81 million at year end 1991 to $202 million at year end 1992.

V. Accounting Developments

Environmental matters further of course have accounting implications for issuers. Generally accepted accounting principles ("GAAP"), specifically FASB Statement No. 5, "Accounting for Contingencies," require 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. FASB Interpretation No. 14,

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11 Letter from Richard L. Hembra, Director, Environmental Protection Issues, GAO, to John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives, and to Ron Wyden, U.S. House of Representatives, dated October 14, 1992.

"Reasonable Estimation of the Amount of a Loss" ("FIN 14"), states that if the estimated amount of loss is within a range of amounts, and some amount within the range appears to be a better estimate than any other, then that amount should be accrued. FIN 14 adds that when no amount within the range is a better estimate than any other amount, the minimum amount in the range should be accrued.

Although there has been some improvement in this area, it is still my impression that accruals concerning environmental liability are not showing up in the financial statements as quickly as I believe that they should be. Judging from the 62% figure that I cited earlier, this concern appears to be well-founded.[12]

However, the Price Waterhouse Survey does indicate some improvement in this area. Expensing costs as they are paid during the cleanup process, referred to as "pay-as-you-go" accounting, is not typically considered GAAP unless the amounts involved are not material. The percentage of survey respondents indicating that they used the "pay-as-you-go" method decreased from 28% in the previous survey to 15% in the current survey.[13] Although there needs to be even more improvement, I am encouraged by the reduction in the use of "pay-as-you-go" accounting and by the increase in the use of accrual accounting.

One recent accounting development in the environmental liability disclosure area was the meeting last month of the Financial Accounting Standards Boards's ("FASB") Emerging Issues Task Force ("Task Force"). On the Task Force agenda were a variety of accounting issues, including two issues relating to the recognition and measurement of contingent losses arising from the recognition of environmental liabilities. Those accounting issues are: (1) under what circumstances is it appropriate to measure on a present-value basis an environmental liability, and (2) under what circumstances is it appropriate to offset the

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12 See supra note 5.

13 Price Waterhouse Survey, supra note 5, at 12.

charge to income for the recognition of an environmental liability with a potential claim for recovery from an insurer or another party.

With respect to the first issue, the discounting of environmental liabilities, the accounting staff of the Commission has taken the position that discounting of environmental liabilities to reflect the time value of money is appropriate only if the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for each specific cleanup site. Any asset that is recognized relating to recovery of the recognized liability also would be discounted to reflect the time value of money. If an issuer can estimate only a range of possible loss arising from the recognition of the environmental liability, and no amount within that range is a better estimate of that environmental liability than any other amount within that range, the staff believes that discounting of that environmental liability would not be appropriate because the aggregate obligation for that environmental liability is not fixed or reliably determinable.[14]

Apparently the Task Force did not reach a consensus on discounting of environmental liabilities but did request that an Issue Summary be prepared for a future meeting. That Issue Summary would address: (1) the definition of "reliably determinable," (2) whether the measurement of the environmental liability should take into consideration inflation, changes in technology, and improved efficiencies, among other things, and (3) the selection of an appropriate discount rate.

With respect to the second issue, offsetting expected recoveries, the accounting staff of the Commission has taken the position that the recognition of an environmental liability should be evaluated independently of any potential claim for recovery. According to the

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14 Letter from Walter P. Schuetze, Chief Accountant, Commission, to Timothy S. Lucas, Chairman, Emerging Issues Task Force, FASB, dated March 9, 1993 ("Schuetze Letter").

staff, the loss arising from the recognition of an environmental liability may not be reduced by a claim for recovery that is only reasonably possible of recovery. That loss may be reduced only by a claim for recovery that is probable of realization.[15]

With respect to this second issue, it is my understanding that the Task Force reached a consensus that the recognition of an environmental liability should be evaluated independently of any potential claim for recovery (a two event approach) and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable, not reasonably possible, of realization. This is consistent with the Commission's staff position.

I wish to stress to this audience the importance of evaluating independently the recognition of an environmental liability from any potential claim for recovery. In the previous Price Waterhouse Survey, only 21% of the companies responding to the survey considered potential insurance recoveries, and only 29% considered potential recoveries from other PRPs. In the most recent survey, 69% of the companies responding indicated that they now consider potential insurance recoveries, and 80% are now looking at recoveries from PRPs.[16] I wish to emphasize that the potential for a third party recovery does not necessarily translate into a probable recovery but may only represent a reasonably possible recovery.

In assessing the probability of a third party recovery, such as through insurance, an issuer should consider the success of similar claims and the insurer's financial viability. Environmental insurance coverage and liability for contribution are often litigated issues, and it is extremely difficult to predict the outcome of this litigation. This is evident by the disparity in results reached by courts in different states on the question of an insured's

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[15] See Schuetze Letter, supra note 15.

[16] See Price Waterhouse Survey, supra note 5, at 20.

ability to obtain coverage for environmental claims, even when interpreting the same policy language. Issuers should exercise caution in this area. I expect that Commission staff will continue to scrutinize carefully the disclosures of both issuers and insurers in this area.[17]

There is another environmental liability accounting development that I wish to mention briefly. The American Institute of Certified Public Accountants ("AICPA") held an Environmental Issues Roundtable earlier this year. I commend the AICPA for holding such a forum, since I believe that it is now appropriate to evaluate problems related to applying existing accounting and auditing standards to environmental matters. It is my understanding that as a result of this Roundtable, the AICPA has determined to initiate, with others, a project to provide additional guidance concerning: (1) the recognition of environmental liabilities for problems incurred in the past within the constraints of FASB Statement No. 5 (Superfund-type problems), and (2) the appropriate auditing procedures regarding detection of environmental liabilities.

While I did not attend the Roundtable, I was provided with the written materials used; and I wish to bring those materials to your attention. You may find them useful.

Finally, in the accounting area, I understand that Commission accounting staff have almost completed the drafting of a Staff Accounting Bulletin ("SAB") which interprets the accounting literature relating to measurement, display, and disclosure regarding contingent losses, such as product and environmental liabilities. Among other things, the SAB will reflect positions that Commission staff has adopted during the last two years.

For reasons unknown to me, this SAB has not yet been finally completed and issued. I am of the opinion that its publication would be a welcome development for practitioners in the environmental liability disclosure area. At a minimum, the current practice remains mixed with regard to the timing of recording environmental cleanup liabilities, and the SAB

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[17] See supra notes 4 and 11.

may provide some guidance to improve this practice. Given the importance that the new administration has apparently placed on environmental matters, I suspect that a new chairman will treat the issuance of this SAB as a much higher Commission priority.

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, as estimating cleanup costs becomes easier, and as insurer coverage litigation consistency is achieved, earlier recognition of environmental liabilities and appropriate treatment of potential third party recoveries in financial statements will result.

VI. CONCLUSION

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.

I am pleased to observe the heightened awareness of the need for, and the improvements in, the practice of environmental liability disclosure that have apparently taken place. This is reflected in the Price Waterhouse Survey where 23% of the respondents reported that they have empowered a board committee to oversee the company's environmental compliance, up from 14% in the prior survey. One-third of the respondent companies also now have written environmental accounting policies, up from only 11% in the previous survey. Further, 26% of the respondents now disclose their environmental accounting policy in the accounting policies footnote to their financial statements --- a significant increase over only 4% in the prior survey.[18] I hope that this progress continues.

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[18] See Price Waterhouse Survey, supra note 5, at 1.

In conclusion, I challenge each of you here today to acquaint yourselves with the environmental regulations and to focus seriously on whether your employer or client has adequately disclosed the short-term and long-term effects of environmental laws on their operations.