Remarks Of

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Recent Trends Concerning Environmental Disclosure

Environmental Group of Organization
Resources Counselors
Washington, D.C.
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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. 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.

A study recently 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

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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.

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 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 and disclosure thereof. 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 this 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. I wish to mention this issue briefly since I am of the opinion that Commission staff should scrutinize carefully the adequacy of the disclosures by issuers in the area of Clean Air Act compliance costs.

II. SUPERFUND DEVELOPMENTS

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 Potentially 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.

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.

It is interesting to note that the scope of environmental liability under the Superfund legislation appears to be in the process of narrowing with respect to at least two parties while the scope remains broad with respect to the remaining parties.

First, the EPA recently issued a final rule governing the liability of lenders under federal Superfund law. The new rule focuses upon the secured creditor exemption found in the Superfund statute, by which persons holding indicia of ownership primarily to protect a security interest in the facility are exempt from liability. If such a person participates in the management of the facility, however, the exemption will not be available. There has also been substantial legislative interest in broadening the secured creditor exemption.

Briefly, the final EPA Superfund lender liability rule clarifies and specifies the range of permissible activities that may be undertaken by lenders without exceeding the bounds of the secured creditor exemption. A lender will not be deemed to be participating in management if its involvement is limited to financial and administrative aspects of the borrower's operations. The new rule also makes the exemption available to lenders when they foreclose upon and take title to contaminated property, as long as the lender

attempts diligently to sell or otherwise dispose of the facility. I will mention the Superfund lender liability issue again shortly.

Second, an intense struggle is currently underway at the EPA, in the Congress, and in the courts over municipal liability under Superfund.[2] The U.S. Court of Appeals for the Second Circuit ruled in 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.[3]

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.

The announced EPA policy in this area is that municipalities may be PRPs like private parties and that municipal waste may be considered hazardous substances.[4] However, in practice, it is my understanding that the EPA generally refrains from pursuing

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2 See Semler, "Pulling Municipalities Out of the Dumps," Legal Times (July 27, 1992), at 18.

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

4 "Interim Municipal Settlement Policy," 54 Fed. Reg. 51071 (December 12, 1989).

municipalities that generate and/or transport municipal solid waste (i.e., household garbage) in Superfund actions. This policy, however, does not provide any contribution protection for parties who, although not named by the EPA as PRPs, are brought into the Superfund process by means of third party actions.

Recently, the EPA announced an initiative to resolve the cost allocation issues that are present at sites which contain non-hazardous municipal wastes and industrial hazardous wastes. To date, the EPA has not issued a new policy statement on this issue and, apparently, such a new policy statement is not imminent. In addition, there was legislation pending in the last Congress that would have granted municipalities special status under Superfund and effectively freed them from most Superfund liability.

The environmental liability developments in the lender, and municipality area bear watching since that trend will have a major impact on the evolution of the Superfund program. Along these lines, I understand that there was an ill fated legislative attempt during the last Congress to also narrow the Superfund liability of some defense contractors. The continuation of this selective liability narrowing trend will 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 worth noting in the Superfund area is the release of a study this summer by a "think tank" group called Resources For the Future which focused on how liability is assigned for Superfund cleanups.[5] The study analyzes the strengths and weaknesses of the current liability scheme and various alternatives to it. The authors concluded that none of the approaches emerge as a clear winner. This study of potential alternatives to existing liability standards is pertinent at this time particularly in view of the trend that is developing concerning disparate liability treatment for different parties and also since Superfund is scheduled for reauthorization in 1994. The authors concluded that more data is needed to fully evaluate the financial implications of the present Superfund program and any proposed alternatives. Specifically, the authors point out that little information is available on the actual aggregate costs of site cleanups and on the identity of the parties paying for the studies and for the cleanup at individual sites.

Certainly the potential for large losses attributable to environmental problems is an important concern that many investors

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[5] Probst & Portney, Assigning Liability For Superfund Cleanups, An Analysis of Policy Options, (Resources For the Future 1992).

will factor into their investment decisions. One need only look at the newspaper to learn of growing environmental problems which pose substantial potential environmental liabilities. For example, the local 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.[6] The Tennessee Study estimates the cleanup effort of the underground storage tank problem to cost nationally as much as $67 billion.

In another example, in a recent EPA action, a group of 200 companies agreed to pay the government over $41 million to settle a Superfund toxic-waste case involving a Massachusetts site. Interestingly, the settling companies have sued a third company alleging that it is partially responsible for the contamination and seek to recover much of the cleanup costs from this third party.[7] The third party company, as a lender interestingly enough, had hired a consultant to help manage the site in order to protect its loan principal when the operator of the site defaulted on the loan. The settling companies, none of whom were the now-defunct site operator, charge that the third party company effectively became a co-operator of the

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

[7] "Firms Settle Superfund Case for Silresim Site," The Wall Street Journal (Oct. 8, 1992), at C11.

site during a period when the toxic spills occurred. This case is being observed closely since it could set a precedent on lender liability in toxic-spill cleanup cases.

For the third and last example, it has been reported that one of the major threats to the solvency of the property-casualty insurance industry is the risk of contract reinterpretation that could impose enormous unforeseen environmental cleanup costs.[8] 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, insurers, investors, underwriters, rating agencies, and acquisition-minded companies, among others.

III. PRINCIPAL REPORTING REQUIREMENTS

A. Historical Role of the Commission

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

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[8] See Neilson, "Regulation Should be Proactive to Head Off Insolvency," The Business Journal (Portland, Oregon)(Dec. 2, 1991), at 7.

Commission role of pressing for clear disclosure of all environmental information that is economically material to the issuer.[9]

The general antifraud provisions of the federal securities laws impose liability on persons who make false statements or omissions of material facts in connection with the offer, 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.

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 in 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.[10] In addition, several past prominent enforcement actions instituted by the Commission against issuers that failed to disclose

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

[10] See, e.g., Securities Act Release Nos. 33-5170, 34-9252 (July 19, 1971); Exchange Act Release No. 5386 (April 20, 1973).

known environmental liabilities and compliance costs have highlighted the importance of accurate disclosure in this area.[11]

B. Regulation S-K

Three provisions of Regulation S-K have particular significance for issuers that are subject to potential environmental liabilities and risks. New Regulation S-B, which applies 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

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[11] See In the matter of United States Steel Corporation, Exchange Act Release No. 16223 (Sept. 22, 1979); In the matter of Occidental Petroleum Corp., Exchange Act Release No. 16950 (July 2, 1980); SEC v. Allied Chemical Corp., No. 77-373 (D.D.C. filed March 4, 1977).

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.[12] 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 the Commission treats MD&A disclosure very seriously.[13] I would

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

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

advise issuers to take their MD&A environmental related disclosure responsibilities very seriously as well.

IV. ACCOUNTING AND DISCLOSURE RELATING TO ENVIRONMENTAL LOSS CONTINGENCIES

Beyond the narrative discussions mandated by Regulation S-K, environmental matters also may have accounting implications for issuers. Generally accepted accounting principles, 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.

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 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.[14]

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[14] In contrast, however, the FASB Emerging Issues Task Force has recently provided guidance indicating that the cost of improvements necessary to prevent further environmental

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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 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

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[14](...continued)
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.

understanding that the Commission's staff is presently comparing Forms 10-K from one year to another to ensure that this uninformative disclosure is being updated or changed appropriately.

It is also 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. Environmental insurance coverage and liability for contribution are often litigated issues, and it is extremely difficult to predict the outcome of this litigation. Certainly the present 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 confirmed by the recent report issued by the Rand Corporation Institute for Civil Justice ("Rand Report").[15] 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

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

coverage. The Rand Report also concluded that insurance companies are fighting coverage questions because they face tremendous potential adverse financial consequences once their coverage is established. Thus, the findings of the Rand Report suggest that some disclosures made by issuers concerning the probability of insurance recoveries for Superfund liabilities are in fact questionable. In my opinion, the Commission should scrutinize carefully the disclosures of both issuers and insurers in this area.

There are two recent environmental accounting developments that I wish to mention briefly. First, it is my understanding that the American Institute of Certified Public Accountants ("AICPA") is organizing a roundtable discussion on environmental accounting and disclosure issues to be held next year. I view such an event as a positive development and encourage the AICPA to hold such a roundtable.

Second, it is my understanding that Commission accounting staff is considering issuing guidance in the form of a Staff Accounting Bulletin ("SAB") that 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.

It is my further understanding that the staff is currently finalizing its views with respect to certain additional matters which may be addressed in the SAB such as: (1.) under what circumstances, if any, may the environmental liability be discounted to its estimated present value? (2.) under what circumstances might the staff require separate display of liability and the related receivable from the insurance company on the face of the balance sheet in financial statements filed with the Commission? This SAB will prove to be an important development in the environmental accounting area.

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 environmental liabilities in financial statements will result.

V. 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. At the Commission, the large dollar

amounts of anticipated Superfund costs, Clean Water Act costs, Clean Air Act 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 liability disclosure in connection with its review of both issuer and insurer 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 Commission's Division of Enforcement.

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.