



## TABLE OF CONTENTS

	<u>PAGE</u>
I. Introduction.....	1
A. Background.....	1
B. Executive Summary.....	1
II. Specific Disclosure Requirements .....	3
A. Item 101 – Description of Business .....	4
B. Item 103 – Legal Proceedings.....	6
1. Is There an Environmental “Proceeding”?.....	6
2. Three-Prong Disclosure Test.....	7
C. Item 303 – Management’s Discussion and Analysis of Financial Condition and Results of Operations.....	11
1. Material Events and Uncertainties.....	11
2. Off-Balance Sheet Arrangements.....	14
3. Long-Term Contractual Liabilities.....	15
D. Item 503(c) – Risk Factors.....	15
E. Form 20-F Disclosure Requirements on Foreign Private Issuers .....	16
1. Item 4.D – Environmental Issues Affecting a Material Asset.....	16
2. Other Disclosure Requirements.....	16
3. Financial Statements.....	16
III. Recognition and Disclosure of Environmental Liabilities in Financial Statements.....	17
A. Traditional Accounting Concepts .....	17
1. Financial Accounting Standard No. 5 – Accounting for Contingencies .....	17
2. FASB Interpretation No. 14 – Loss Estimation.....	18
3. Staff Accounting Bulletin No. 92 – Accounting and Disclosure of Loss Contingencies.....	18
4. AICPA Statement of Position 94-6 – Disclosure of Significant Risks and Uncertainties.....	20
5. AICPA Statement of Position 96-1 – Environmental Remediation Estimates.....	21
6. Staff Accounting Bulletin No. 99 – Materiality .....	22
B. Fair Value Accounting.....	22
1. Financial Accounting Standard No. 157 – Fair Value .....	22
2. Financial Accounting Standard No. 143 and FASB Interpretation No. 47 – Asset Retirement Obligations.....	24
3. FASB Interpretation No. 45 – Guarantees/Indemnities .....	26
4. Financial Accounting Standard No. 141R – Liability Recognition upon Business Combination.....	27
C. FASB Proposed Statement on FAS 5 and FAS 141R Loss Contingency Footnote Disclosure .....	30
IV. Enforcement of Environmental Disclosure Requirements.....	32
A. SEC Enforcement Actions Regarding Environmental Disclosure.....	33
1. SEC Enforcement Actions Regarding Environmental Disclosure Outside of the Financial Statements.....	33

2.	SEC Enforcement Actions Regarding Environmental Disclosure in Financial Statements .....	36
B.	Case Law Regarding Environmental Disclosure .....	39
V.	Disclosure of Climate Change Risks .....	42
A.	Current Regulation of Climate Change.....	42
B.	Existing Disclosure Requirements .....	43
C.	Calls for Guidance on Climate Change Disclosure .....	44
1.	Ceres Petition to the SEC and Other Shareholder Efforts .....	44
2.	Congressional Activity .....	46
D.	New York Subpoenas Regarding Climate Change Disclosure .....	47
E.	Additional Frameworks for Disclosure.....	49
VI.	Some Practical Considerations .....	49
A.	General.....	49
B.	Environmental Accounting .....	50
C.	Climate Change.....	51
VII.	Conclusion .....	52

## **I. INTRODUCTION**

### **A. Background**

Preparing environmental disclosure for Securities and Exchange Commission (“SEC”) filings has always been a complicated task. Although most of the securities and accounting rules governing environmental disclosure have been in place for some time, environmental costs and liabilities can take various forms, the key facts are often difficult to ascertain and the underlying environmental laws (and their enforcement) are constantly changing. Further complicating matters is the fact that many publicly traded company operations are subject to multiple jurisdictional requirements, from very local to international or supranational regimes. Finally, and particularly problematic for disclosure purposes, is the fact that environmental matters often take many years to investigate, address and resolve, which raises significant estimation and other challenges.

This memorandum describes the current requirements relating to environmental disclosure in SEC filings. Many of the disclosure obligations relate to costs and liabilities that are familiar to all companies—such as costs to investigate and remediate contamination and costs and liabilities arising from the failure to comply with laws or the existence of environmental litigation—but there are some recent developments that companies must consider.

Certain new and proposed changes to environmental accounting rules may affect current and near-term qualitative and quantitative disclosure. In particular, the Financial Accounting Standards Board (“FASB”) is looking for more footnote disclosure about a company’s environmental liabilities. There is also a general movement towards “fair value” (or mark-to-market) accounting. Complying with these changes can be difficult given the uncertainty in the timing and cost of many environmental liabilities, as noted above.

Climate change must also be considered when preparing SEC disclosure. While there are many uncertainties, and the current profound international economic crisis may adversely affect the ability of the new U.S. administration to move forward with aggressive climate change laws, costs relating to climate change are already affecting some companies and will, in the future, affect many others. Certain environmental interest groups and regulators have made climate change disclosure a focus of their agendas, and companies must therefore consider practical and political issues in addition to purely legal requirements.

Finally, it is worth noting that some of these developments may result in a need for companies to collect information not currently being collected (from the measurement of carbon emissions to new “fair value” estimates to careful tracking of legal developments).

This memorandum discusses these recent developments and provides practical guidance on how to analyze and address the related disclosure issues facing your company.

### **B. Executive Summary**

- A duty to disclose actual or potential environmental liabilities in SEC filings may arise under:
  - the specific disclosure requirements of Regulation S-K promulgated under the Securities Act of 1933, as amended (the “Securities Act”);

---

*This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal or accounting advice.*

- 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 with respect 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 environmental issues a public company must disclose are **generally** the same as for any other issues:
  - 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 **Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) section and its financial statements and related disclosure in the accompanying footnotes**:
  - Any known trend, demand, commitment, event or uncertainty that the company cannot conclude would not reasonably have a material effect on its financial condition or results of operations, must be disclosed.
  - Environmental liabilities for which the company has information that creates a reasonable likelihood of a material effect on its financial condition or results of operations, should also 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.
  - Certain environmental liabilities and obligations may need to be recognized in its financial statements and discussed 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:
    - involving a domestic governmental agency and a potential fine or penalty in excess of \$100,000;
    - that could result in costs to the company in excess of ten percent of its current consolidated assets; or

---

*This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal or accounting advice.*

- that is otherwise “material” to the company’s business or financial condition.
- With respect to its **Risk Factors** section, the company must disclose:
  - Significant environmental risks affecting it, such as those relating to climate change, contamination, noncompliance, litigation and hazardous material exposure issues.
- **Section II** of the memorandum provides a more thorough discussion of these rules, including what “material” may mean in the particular context in which the term is used.
- As noted above, there are several **key accounting standards and guidance** governing environmental liabilities. Historically, most environmental liabilities have been governed by an accounting standard called “FAS 5”, which requires companies to accrue a liability if that liability is probable (i.e., likely) and reasonably estimable. After the issuance of FAS 5, accounting regulators clarified its scope and application in a number of guidance documents. More recently, certain types of environmental liabilities have been carved out of the FAS 5 framework and now must be quantified at their “fair value”, including: (i) environmental asset retirement obligations; (ii) certain environmental guarantees and indemnities; and (iii) environmental liabilities acquired in a business combination. **Section III** describes these accounting standards and guidance and some of the practical realities of their application.
- There are a few SEC enforcement actions and other cases interpreting environmental disclosure requirements, which may provide some useful perspectives as disclosure decisions are being made. **Section IV** describes these.
- Developments in the science, law and politics of climate change will need to be considered in the context of a company’s business and financial condition. Certain climate change risks may already be required to be disclosed under existing SEC requirements, and there are ongoing efforts by shareholder/environmental groups and certain (non-SEC) regulators to develop and impose new requirements. **Section V** describes these current requirements and developments.
- Finally, we have attempted to provide some practical guidance to help comply with the increasingly complicated and comprehensive environmental disclosure requirements outlined above, with a particular focus on climate change disclosure and environmental accounting. **Section VI** provides that guidance and **Section VII** provides some general concluding remarks.

## II. SPECIFIC DISCLOSURE REQUIREMENTS

Regulation S-K sets forth specific requirements for the disclosure that a company<sup>1</sup> 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.

---

<sup>1</sup> Whether Regulation S-K (or any of the other rules discussed in this memorandum) applies to a particular registrant depends on the form the registrant will be filing. Most public filings by United States companies will be subject to numerous Regulation S-K disclosure requirements. In contrast, fewer Regulation S-K requirements apply to filings by foreign issuers. See Section II.E of this memorandum for additional information.

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."<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup>

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 requirement to expenses (such as fines and penalties) incurred in complying with environmental regulations.<sup>5</sup> 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:

[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.<sup>6</sup>

---

<sup>2</sup> 17 C.F.R. § 229.101(c)(1)(xii) (2008).

<sup>3</sup> Environmental Disclosure Requirements, Securities Act Release No. 6130, Fed. Sec. L. Rep. (CCH) ¶ 23,507B, at 17,203-4 n.2 (Sept. 27, 1979) [hereinafter "1979 Interpretive Release"] (citing Securities Act Rule 405, 17 C.F.R. § 230.405 (2008) and Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (2008)). *See also TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) [hereinafter "TSC"].

<sup>4</sup> *See* 17 C.F.R. §§ 230.405, 240.12b-2 (2008). In August 1999, the SEC published SAB 99, which provides guidance on evaluating the materiality of misstatements identified in the audit process or preparation of financial statements. Materiality, SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999) [hereinafter "SAB 99"]. *See* Section III.A.6 of this memorandum for a description of SAB 99. Although SAB 99 was "not intended to provide definitive guidance for assessing 'materiality' in other contexts", in practice, the principles set forth may provide additional useful guidance in determining whether environmental information is sufficiently material to warrant disclosure pursuant to Items 101, 103 and 303 of Regulation S-K. SAB 99, *supra*, at 45,151 n.1.

<sup>5</sup> 1979 Interpretive Release, *supra* note 3, at 17,203-5.

<sup>6</sup> 1979 Interpretive Release, *supra* note 3, at 17,203-5 (emphasis added); *see also In re United States Steel Corp.*, Exchange Act Release No. 16,223, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,319, at 82,383 (Sept. 27, 1979) [hereinafter "*In re U.S. Steel*"]. The Second Circuit in *Levine v. N.L. Industries*, 926 F.2d 199, 203-204 (2d Cir. 1991) affirmed this statement. *See* Section IV.B of the memorandum for a discussion of this case.

---

*This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal or accounting advice.*

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.<sup>7</sup>

Under a new regulation adopted in late 2007,<sup>8</sup> the SEC simplified a number of reporting obligations in Regulation S-K, including Item 101, for smaller reporting companies.<sup>9</sup> Effective February 2008, a smaller reporting company may satisfy its obligations under Item 101 by describing the development of its business during the previous three years (as opposed to five years), which description should include, “to the extent material to an understanding of the smaller reporting company,” the “[c]osts and effects of compliance with environmental laws (federal, state and local).”<sup>10</sup> Two features of this provision stand out in comparison with the language in Item 101(c)(xii). First, the language is very general and, in some respects, broader than the language in Item 101(c)(xii). For example, the provision does not specify what type of effects should be discussed, unlike Item 101(c)(xii) which asks for the effects of environmental compliance on capital expenditures, earnings and competitive position. Second, the provision appears to require a discussion only of historical, and not future, costs and effects, unlike Item 101(c)(xii) which explicitly requires projections of material environmental capital expenditures.

In Staff Accounting Bulletin No. 92 (“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) recurring costs associated with managing hazardous substances and pollution in ongoing operations,
- (ii) capital expenditures to limit or monitor such substances or pollutants,
- (iii) mandated expenditures to remediate previously contaminated sites, and
- (iv) other infrequent or nonrecurring cleanup expenses that can be anticipated.<sup>11</sup>

---

<sup>7</sup> 1979 Interpretive Release, *supra* note 3, at 17,203-5.

<sup>8</sup> 17 C.F.R. § 229.101(h)(4)(xi) (2008).

<sup>9</sup> A “smaller reporting company” is generally an issuer (other than an investment company, an asset-backed issuer or a majority-owned subsidiary of a parent that is not a smaller reporting company) that: (i) has a public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter; (ii) in the case of an initial common stock registration statement under the Securities Act or Exchange Act, has a public float of less than \$75 million within 30 days of the date of the filing; or (iii) in the case of an issuer whose public float is calculated as zero, it had annual revenues of less than \$50 million during the most recently completed fiscal year for which audited financial statements are available. 17 C.F.R. § 229.10(f)(1) (2008).

<sup>10</sup> 17 C.F.R. § 229.101(h)(4)(xi) (2008).

<sup>11</sup> Accounting and Disclosures Relating to Loss Contingencies, SEC Staff Accounting Bulletin No. 92, 58 Fed. Reg. 32,843, 32,845 (June 8, 1993) [hereinafter “SAB 92”]. SAB 92 is discussed in greater detail in Section III.A.3 of this memorandum.

*B. Item 103 – Legal Proceedings*

Item 103 of Regulation S-K<sup>12</sup> mandates disclosure of certain types of legal proceedings in which a company or its property is involved.<sup>13</sup> 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.<sup>14</sup> 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.<sup>15</sup> However, Instruction 5 to Item 103 specifically provides that litigation “arising under any federal, state or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary [sic] for the purpose of protecting the environment” shall not be deemed “ordinary routine litigation incidental to the business” and instead mandates disclosure of three different types of environmental litigation:

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

(ii) any administrative or judicial 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 sanctions, or in monetary sanctions of less than \$100,000, exclusive of interest and costs.<sup>16</sup>

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

---

<sup>12</sup> 17 C.F.R. § 229.103 (2008).

<sup>13</sup> 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 (2008).

<sup>14</sup> 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 III of this memorandum for more information.

<sup>15</sup> 17 C.F.R. § 229.103 (2008). 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.

<sup>16</sup> *Id.* at § 229.103, Instruction 5.

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.<sup>17</sup>

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.’”<sup>18</sup> 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.”<sup>19</sup>

Disclosure of actual or contemplated proceedings must include the nature of the relief sought.<sup>20</sup> In the 1979 Interpretive Release, the 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 the governmental authority be provided if such expenditures are likely to be material.<sup>21</sup>

## 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.<sup>22</sup> This requirement can be invoked in a number of ways. For example, in *Wielgos v. Commonwealth Edison Company*<sup>23</sup> a shareholder, Wielgos, charged that Commonwealth Edison (“Edison”) 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.”<sup>24</sup> 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.

---

<sup>17</sup> 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 Co. v. Internorth, Inc.*, 518 F. Supp. 416, 474-475 (N.D.N.Y. 1980).

<sup>18</sup> 1979 Interpretive Release, *supra* note 3, at 17,203-6.

<sup>19</sup> *Id.*

<sup>20</sup> *See id.*

<sup>21</sup> *Id.* This interpretation arose out of a proceeding against U.S. Steel. See *In re U.S. Steel*, *supra* note 6, at 82,384.

<sup>22</sup> See 17 C.F.R. § 230.405 (2008); see also Gerard A. Caron, Comment, *SEC Disclosure Requirements for Contingent Environmental Liability*, 14 B.C. Env’tl. Aff. L. Rev. 729, 744 (1987).

<sup>23</sup> 892 F.2d 509 (7th Cir. 1989).

<sup>24</sup> *Id.* at 510.

Wielgos charged that Edison 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.’”<sup>25</sup> The appeals court interpreted materiality to depend “not only on the magnitude of an effect but also on its probability.”<sup>26</sup> 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 appeals court chose not to follow the lower court’s reasoning. Rather, it decided the case “without regard to materiality,” reasoning that Edison had disclosed the proceeding in sufficient detail to comply with the requirements of Item 103. Edison had disclosed that it was building five nuclear reactors and was applying for operating licenses from the NRC, and that environmental groups were opposing its applications for licenses. The court stated:

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.<sup>27</sup>

Edison 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.”<sup>28</sup>

(ii) *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.”<sup>29</sup> 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.<sup>30</sup>

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.”<sup>31</sup> 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.

---

<sup>25</sup> *Id.* at 517.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* It is interesting to note that both the district court and the appeals court assumed without any discussion that an application for a license is a “proceeding” under Item 103.

<sup>29</sup> 17 C.F.R. § 229.103 Instruction 5(B) (2008).

<sup>30</sup> See Caron, *supra* note 22, at 745.

<sup>31</sup> 17 C.F.R. § 229.103 Instruction 2 (2008).

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.”<sup>32</sup>

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 third prong of the test applies to proceedings to which any government, foreign or domestic, is a party<sup>33</sup> and 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.”<sup>34</sup>

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.”<sup>35</sup>

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.<sup>36</sup> A company cannot defend itself with the argument that its judgment was made in good faith if the SEC determines that, given the facts known by the company, the judgment was unreasonable.<sup>37</sup>

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

---

<sup>32</sup> Proposed Amendments to Item 5 of Regulation S-K Regarding Disclosure of Certain Environmental Proceedings, Securities Act Release No. 6315, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,867, at 84,288 (May 4, 1981) [hereinafter “Proposed Amendments”].

<sup>33</sup> See SEC Department of Corporate Finance Compliance & Disclosure Interpretations, Regulation S-K, last updated July 3, 2008, available at <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm> [hereinafter “CD&I”]. The SEC explained in the CD&I that the reference in Instruction 5 to “local provisions” is “sufficiently broad to require disclosure of environmental actions brought by a foreign government.”

<sup>34</sup> Proposed Amendments, *supra* note 32, at 84,288.

<sup>35</sup> *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 22, at 747.

<sup>36</sup> See Caron, *supra* note 22, at 747 n.160.

<sup>37</sup> See *id.* at 747.

\$100,000.<sup>38</sup> 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.”<sup>39</sup> 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 U.S. Environmental Protection Agency (“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”?

According to a 1989 release,<sup>40</sup> “[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.”<sup>41</sup> 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.”<sup>42</sup> 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:

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.<sup>43</sup>

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 cleanup 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.

---

<sup>38</sup> Adoption of Integrated Disclosure System, Securities Act Release No. 6383, [1982 Accounting Series Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328, at 63,004 (Mar. 3, 1982).

<sup>39</sup> *Id.*

<sup>40</sup> See Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosure, Securities Act Release No. 6835, Fed. Sec. L. 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 Release”]. Although this release focuses on the disclosure required in the MD&A section, it also provides guidance in interpreting Item 103.

<sup>41</sup> *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.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* (citing Thomas A. Cole, Esq., SEC No-Action Letter, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,962, at 78,814 (Jan. 31, 1989) [hereinafter “Cole”]). See also CD&I, *supra* note 33.

In determining its disclosure duty under Instruction 5(A) or 5(B), a PRP may consider the “availability of insurance, indemnification or contribution”.<sup>44</sup> 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.<sup>45</sup>

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

Item 303 of Regulation S-K<sup>46</sup> describes the disclosures required in the MD&A section of a company’s filings. While environmental matters may be implicated by any of the requirements of Item 303,<sup>47</sup> three of these deserve special attention from an environmental perspective: the requirements to disclose material events and uncertainties; off-balance sheet arrangements; and certain contractual obligations.

*1. Material Events and Uncertainties.* Item 303 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.”<sup>48</sup>

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.<sup>49</sup> In the release, the SEC attempted to clarify the distinction set out in Item 303 between two types of forward-looking information: (i) “prospective information,” which a registrant must disclose, and (ii) “voluntary forward-looking information,” disclosure of which is optional.<sup>50</sup> 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.”<sup>51</sup> Essentially, voluntary forward-looking information is less certain than prospective information.

---

<sup>44</sup> *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 III of this memorandum.

<sup>45</sup> 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, *supra* note 43. Note, however, that the existence of an indemnification might be an issue in financial statement disclosure. *See* Section V of this memorandum.

<sup>46</sup> 17 C.F.R. § 229.303 (2008).

<sup>47</sup> For example, significant Superfund or other remediation-related payments may need to be disclosed under Item 303(a)(1), which requires a company to identify “any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the [company’s] liquidity increasing or decreasing in any material way.” *Id.* at § 229.303(a)(1).

<sup>48</sup> *Id.* at § 229.303(a), Instruction 3.

<sup>49</sup> MD&A Release, *supra* note 40, at 62,844.

<sup>50</sup> *Id.* at 62,842 (emphasis omitted).

<sup>51</sup> *Id.*

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.<sup>52</sup>

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

*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.

*[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 recovery may be factored into the determination of whether a material future effect is not reasonably likely to occur.<sup>53</sup>

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.<sup>54</sup> 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.<sup>55</sup>

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.<sup>56</sup>

---

<sup>52</sup> *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.

<sup>53</sup> *Id.* at 62,844, 62,845.

<sup>54</sup> *See id.* at 62,843 n.14 (citing *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)).

<sup>55</sup> 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. 33-8056, 2002 SEC LEXIS 148 (January 22, 2002) [hereinafter "2002 MD&A Statement"].

<sup>56</sup> *But see* Section III of this memorandum for a discussion of accrual of contingent liabilities and financial disclosure.

Although case law relating to environmental disclosure required pursuant to Item 303 is sparse, one decision suggests that companies should pay close attention to certain “boilerplate” language often used in presenting forward-looking information. In *Endo v. Albertine*,<sup>57</sup> 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.<sup>58</sup>

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 protected by Securities Act Rule 175 as a forward-looking statement,<sup>59</sup> 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.<sup>60</sup> 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.

In 2006, the SEC’s Division of Corporate Finance (the “Division”) issued new guidance on disclosing loss contingencies under Item 303.<sup>61</sup> The Division noted that a company may need to disclose a loss contingency, such as environmental contamination, even before accounting recognition of such contingency, if it becomes aware of information that creates a reasonable likelihood of a material effect on its financial condition or results of operations.<sup>62</sup> It also explained that such disclosure should include:

---

<sup>57</sup> 863 F. Supp. 708 (N.D. Ill. 1994), *aff’d*, *Endo v. Arthur Andersen & Co.*, 163 F.3d 463 (7th Cir. 1999).

<sup>58</sup> *Id.* at 714-15.

<sup>59</sup> 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).

<sup>60</sup> *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. *Id.*

<sup>61</sup> Current Accounting and Disclosure Issues in the Division of Corporation Finance, Prepared by Accounting Staff Members in the Division of Corporation Finance, November 30, 2006, available at <http://www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf>.

<sup>62</sup> While the guidance does not define “reasonable likelihood”, the Division makes clear that a reasonable likelihood of a material effect will often occur before the likelihood of a loss contingency becomes probable and the amount of the loss is reasonably estimable. *Id.* at 45.

- (i) the reasonably likely impact of the loss contingency or, if the company is unable to estimate such impact but a range of amounts is determinable based on the facts, such amounts;
- (ii) a quantification of the accruals and adjustments, costs of legal defense and reasonably likely exposure to additional loss;
- (iii) the assumptions management has made concerning the amounts described in (ii), the reasons these assumptions best reflect the company's exposure and the extent to which the resulting estimates of loss are sensitive to changes in these assumptions;<sup>63</sup>
- (iv) when the underlying event associated with the loss contingency occurred and the developments during the intervening periods which resulted in the establishment or adjustment of accruals;
- (v) the timing of the accounting effects in order to properly convey information about variability; and
- (vi) if a company provides indemnification for matters associated with a discontinued operation and management determines it is reasonably likely the company will incur a material liability, a discussion of the relevant terms of the indemnification, including the duration of the agreement and the extent of coverage or exposure.<sup>64</sup>

The Division also advised companies to consider whether it is necessary to discuss loss contingencies on both an aggregated and disaggregated basis, since the particular characteristics of and uncertainties regarding certain loss contingencies may make aggregated disclosure insufficient to provide material information necessary to an understanding of the loss contingency position.<sup>65</sup>

2. *Off-Balance Sheet Arrangements.* Item 303(a)(4) requires companies 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.<sup>66</sup> 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.

An "off-balance sheet arrangement" includes "any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the company is a party"<sup>67</sup> under which the company has either:

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

---

<sup>63</sup> The Division noted that the need to address the underlying assumption is "especially important" when there is a material difference between the range of reasonably possible loss and the amount accrued. *Id.* at 46.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> 17 C.F.R. § 229.303(a)(4) (2008).

<sup>67</sup> Item 303(a)(4)(ii) of Regulation S-K.

(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”;<sup>68</sup> 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 may be required.

3. *Long-Term Contractual Liabilities.* Item 303(a)(5) requires a company to disclose all payment amounts due under long-term contractual liabilities on its balance sheet.<sup>69</sup> 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. 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 long-term liabilities on their balance sheets.<sup>70</sup>

#### D. *Item 503(c) – Risk Factors*

A registration statement filed with the SEC must contain a discussion of the most significant factors that make the offering speculative or risky, pursuant to Item 503(c) of Regulation S-K.<sup>71</sup> Annual Reports on Form 10-K must also include this information,<sup>72</sup> and Quarterly Reports on Form 10-Q must set forth any material changes to the risk factors described in the Annual Report.<sup>73</sup> Item 503(c) indicates that the company should explain how each risk affects the issuer or the securities being offered and should not describe risks that could apply to any issuer or any offering.<sup>74</sup>

Though Item 503(c) does not specifically mention environmental risks, such risks must be disclosed if significant to the company or offering. Depending on a company’s particular situation, it may need to disclose risks related to climate change, contamination and remediation liabilities, compliance with environmental laws (including enforcement actions and permitting matters), environmental litigation and hazardous material exposure issues (including toxic tort and asbestos claims).

---

<sup>68</sup> Item 303(a)(4)(ii) of Regulation S-K.

<sup>69</sup> 17 C.F.R. § 229.303(a)(5) (2008).

<sup>70</sup> *Id.*

<sup>71</sup> 17 C.F.R. § 229.503(c) (2008).

<sup>72</sup> See Annual Report (Form 10-K), Part I, Item 1A. Risk Factors.

<sup>73</sup> See Quarterly Report (Form 10-Q), Part II, Item 1A. Risk Factors.

<sup>74</sup> 17 C.F.R. § 229.503(c) (2008).

E. *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.<sup>75</sup>

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 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 II.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. Item 5.E, Off-Balance Sheet Arrangements, requires a discussion of the company’s off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the company’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. 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 (“GAAP”) and Regulation S-X”.<sup>76</sup> 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.

---

<sup>75</sup> 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.

<sup>76</sup> Item 17, Form 20-F, *supra* note 75.

### III. RECOGNITION AND DISCLOSURE OF ENVIRONMENTAL LIABILITIES IN FINANCIAL STATEMENTS

Since 1975, the SEC, FASB and the AICPA have issued various standards and guidance regarding what constitutes U.S. GAAP in recognizing and disclosing environmental liabilities in financial statements. Traditionally, the most important accounting guidance related to environmental liabilities was FASB's Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* ("FAS 5"),<sup>77</sup> and the various standards that interpreted or supplemented it.

A number of recent changes have complicated accounting for environmental liabilities. Perhaps most importantly, there has been a movement in accounting towards "fair value" measurement, or "mark-to-market" accounting, both in the U.S. and internationally.<sup>78</sup> As part of this movement, FASB has issued several standards requiring certain liabilities to be measured at their fair value, including environmental asset retirement obligations, certain environmental guarantees and indemnities, and environmental liabilities acquired in a business combination. As discussed in greater detail below, calculating fair value is complicated, particularly in the environmental context. Nonetheless, the movement towards fair value is expected to culminate in *all* environmental liabilities being recognized, measured and disclosed in the financial statements pursuant to fair value standards.

Other sweeping changes are expected that could also affect environmental accounting. In particular, FASB and the International Accounting Standards Board ("IASB") have been working to harmonize and create a uniform GAAP to govern both U.S. and foreign companies. The SEC has expressed strong support for this convergence, which likely would occur over the next five to ten years. The full impact of these changes on environmental accounting will not be known until FASB and IASB adopt their new standards.

The following is a brief summary of the traditional accounting concepts and fair value rules as they relate to environmental liabilities. This section also describes a recent and ongoing FASB initiative to improve footnote disclosure of "loss contingencies", which some investors claim have been inadequately disclosed under existing standards.

#### A. *Traditional Accounting Concepts*

##### 1. *Financial Accounting Standard No. 5 – Accounting for Contingencies*

In 1975, FASB issued FAS 5, which requires accrual of an estimated loss from a "loss contingency"<sup>79</sup> if (i) it is probable<sup>80</sup> that a liability has been incurred (or an asset has been impaired) at the

---

<sup>77</sup> ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 1975) [hereinafter "FAS 5"].

<sup>78</sup> Fair value measurement has generated significant controversy and has been cited as contributing to the current economic crisis. Responding to this concern, Congress included a provision in the Emergency Economic Stabilization Act, adopted on October 3, 2008, requiring the SEC to conduct a study on mark-to-market accounting. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, div. A, § 133, 122 Stat. 3765. As discussed in Section III.B.1 below, the required study, issued in December 2008, expressed support for fair value measurement. See SEC, Office of the Chief Accountant and Div. of Corporation Finance, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting* (Dec. 30, 2008), available at <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf>.

<sup>79</sup> FAS 5 defines "loss contingency" as an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. FAS 5, *supra* note 77, at para. 1.

date of the financial statements in question<sup>81</sup> and (ii) the amount of the loss can be *reasonably estimated*. In addition, narrative disclosure of the nature of the accrual, and in some circumstances, the amount accrued, may be necessary for the financial statements not to be misleading.<sup>82</sup> 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<sup>83</sup> that a loss . . . may have been incurred”.<sup>84</sup> Such disclosure should (a) indicate the nature of the loss 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.

In June 2008, as part of a comprehensive reevaluation of FAS 5, FASB issued an “Exposure Draft”, or essentially a new FASB Statement, to replace and enhance the disclosure requirements in FAS 5. This draft continues to be a work-in-progress. Please see Section III.C below for a detailed description of the relevant portions of this exposure draft.

## 2. *FASB Interpretation No. 14 – Loss Estimation*

One of the most frequently asked questions after the issuance of FAS 5 was whether the amount of a loss was reasonably estimable when a range of losses could be estimated, but no single amount was a better estimate than any other amount within the range. In 1976, the FASB issued an interpretation of FAS 5, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (“FIN 14”)<sup>85</sup> 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.”<sup>86</sup> Thus, companies were encouraged to accrue an amount at least equal to the bottom number of the range.

## 3. *Staff Accounting Bulletin No. 92 – Accounting and Disclosure of Loss Contingencies*

Even after issuance of FIN 14, a number of issues remained unresolved. For example, the SEC became aware that many companies were reducing their environmental accruals 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.

The SEC issued SAB 92 in June 1993. SAB 92 restated, underscored and provided more detail regarding application of the standards described above, and, in particular, it made one extremely

---

(continued...)

<sup>80</sup> “Probable” is defined as “likely to occur.” *Id.* at para. 3.a.

<sup>81</sup> The date of the financial statements is defined as “the end of the most recent accounting period for which financial statements are being presented.” *Id.* at para. 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. *Id.*

<sup>82</sup> *Id.* at para. 9.

<sup>83</sup> “Reasonably possible” is defined as “more than remote but less than likely.” *Id.* at para. 3.b.

<sup>84</sup> *Id.* at para. 10.

<sup>85</sup> REASONABLE ESTIMATION OF THE AMOUNT OF A LOSS, Interpretation No. 14 (Financial Accounting Standards Bd. 1976).

<sup>86</sup> *Id.* at para. 3.

important clarification. Specifically, the SEC noted that it is not appropriate to offset a claim for recovery against a related accrual, *even if* the claim for recovery is probable of realization. This means that a company must take an accrual for any loss contingency meeting the requirements of FAS 5 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 acknowledged that potential sources of recovery may be relevant in determining whether a loss contingency has been disclosed properly, it concluded that separate presentation of the gross accrual and related claim for recovery “most fairly presents the potential consequences of the contingent claim on the company’s resources”.<sup>87</sup>

In addition, SAB 92 in some cases requires registrants to discuss, in the footnotes to the financial statements, uncertainties relating to environmental loss contingencies. 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 an accrual has been taken, while perhaps not probable, is nonetheless reasonably possible.<sup>88</sup> Similar footnote disclosure should be made with respect to uncertainties relating to receipt of insurance or indemnity proceeds.<sup>89</sup> Finally, footnote disclosure may be required simply to permit the reader to clearly understand the nature of the loss contingency, 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;
- (ii) the registrant’s prior experience in remediation, as well as other companies’ clean-up experiences and data released by the EPA or other organizations;
- (iii) existing technology;
- (iv) presently enacted laws and regulations; and
- (v) the likely effects of inflation and other societal and economic factors.<sup>90</sup>

The SEC acknowledges that a company is permitted to record only its share of total costs so long as there is a “reasonable basis for apportionment of costs”.<sup>91</sup> If, however, it is probable that another PRP will not

---

<sup>87</sup> SAB 92, *supra* note 11, 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, at para. 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.

<sup>88</sup> SAB 92, *supra* note 11, at 32,845.

<sup>89</sup> *Id.* 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: “[I]f 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).

<sup>90</sup> SAB 92, *supra* note 11, at 32,844.

<sup>91</sup> *Id.*

fully pay its share of the costs, the company 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 company can estimate a cost, that cost should be recorded. If a company does not believe it can estimate the specific cost, but it can determine a range of costs, 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.<sup>92</sup>

In February 2003, the SEC issued a summary finding that many companies have failed to adequately disclose their environmental loss contingencies and accruals, in particular those required by SAB 92.<sup>93</sup> Following on this summary, we understand, based on anecdotal evidence, that the SEC has consistently included in its comments to company filings a request to expand footnote disclosure to ensure compliance with SAB 92.

#### 4. *AICPA Statement of Position 94-6 – Disclosure of Significant Risks and Uncertainties*

The Accounting Standards Executive Committee of the AICPA issued Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (“SOP 94-6”), in 1994.<sup>94</sup> SOP 94-6 sets forth disclosure requirements relating to certain significant estimates used to determine the carrying amounts of assets or liabilities or in the disclosure of gain or loss contingencies.<sup>95</sup> These disclosure requirements apply if (i) it is at least reasonably possible<sup>96</sup> that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term<sup>97</sup> due to one or more future confirming events and (ii) the effect of the change would be material to the financial statements.<sup>98</sup> If both of these conditions are met, the company must disclose the nature of the uncertainty and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. In addition, if the estimate involves a loss contingency covered by

---

<sup>92</sup> *Id.*

<sup>93</sup> SEC Division of Corporate Finance, *Summary of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies*, available at <http://www.sec.gov/divisions/corpfin/fortune500rep.htm>.

<sup>94</sup> DISCLOSURE OF CERTAIN SIGNIFICANT RISKS AND UNCERTAINTIES, Statement of Position 94-6 (American Inst. of Certified Public Accountants 1994) [hereinafter “SOP 94-6”].

<sup>95</sup> *Id.* at para. 12.

<sup>96</sup> SOP 94-6 uses the definition of “reasonably possible” from FAS 5, namely that the chance of an event occurring is more than remote, but less than likely. *Id.* at para. 13 n.7.

<sup>97</sup> SOP 94-6 defines “near term” as a period of time not to exceed one year from the date of the financial statements. *Id.* at para. 7.

<sup>98</sup> *Id.* at para. 13.

FAS 5, the company must also include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.<sup>99</sup> SOP 94-6 encourages, but does not require, disclosure of the factors that cause the estimate to be sensitive to change. Various environmental estimates, including those related to remediation costs, may be subject to these provisions.

5. *AICPA Statement of Position 96-1 – Environmental Remediation Estimates*

The Accounting Standards Executive Committee of the AICPA issued Statement of Position 96-1, *Environmental Remediation Liabilities* (“SOP 96-1”), in October 1996.<sup>100</sup> SOP 96-1 provides accounting guidance for the recognition, measurement and disclosure of environmental remediation liabilities, which relate to pollution caused by some past act and arise under the federal Superfund law, the federal Resource Conservation and Recovery Act (“RCRA”) or analogous state or foreign laws or regulations.<sup>101</sup> 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 primarily restates rules and concepts set forth in preceding bulletins and standards, it provides additional helpful guidance.<sup>102</sup> In particular, SOP 96-1 provides a list of “recognition benchmarks” for an environmental remediation liability, at which times the estimate of such environmental remediation liability should be reevaluated. These benchmarks include:

- (i) identification and verification of an entity as a potentially responsible party or when an entity is subject to a RCRA facility permit;
- (ii) receipt of unilateral administrative orders;
- (iii) completion of a feasibility study; and
- (iv) issuance of a record of decision.<sup>103</sup>

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”.<sup>104</sup> SOP 96-1 also states that discounting environmental remediation 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.<sup>105</sup>

---

<sup>99</sup> *Id.* at para. 14.

<sup>100</sup> ENVIRONMENTAL REMEDIATION LIABILITIES, Statement of Position 96-1, at para. A.12 (American Inst. of Certified Public Accountants 1996) [hereinafter “SOP 96-1”].

<sup>101</sup> *Id.* at para. 99. SOP 96-1 does not apply to pollution control costs with respect to current operations, voluntary remediation costs, or costs to restore or close sites upon the cessation of operations thereon or sale thereof (which costs are asset retirement obligations subject to the requirements outlined in Section III.B.2 below). *Id.* at para. 101.

<sup>102</sup> SOP 96-1 incorporated, and effectively nullified, the guidance in FASB Emerging Issues Task Force, Issue No. 93-5, *Accounting for Environmental Liabilities*.

<sup>103</sup> SOP 96-1, *supra* note 100, at para. 119.

<sup>104</sup> *Id.* at para. 124.

<sup>105</sup> *Id.* at para. 132.

6. *Staff Accounting Bulletin No. 99 – Materiality*

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 SAB 99, “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”.<sup>106</sup> 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?

(iii) does the misstatement affect the registrant’s compliance with regulatory requirements?<sup>107</sup>

SAB 99 applies to all aspects of preparing and auditing financial statements, including accruals for environmental loss contingencies and the estimation of environmental capital expenditures and operating expenses.

B. *Fair Value Accounting*

1. *Financial Accounting Standard No. 157 – Fair Value*

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (“FAS 157”),<sup>108</sup> which establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 applies when other accounting pronouncements require or permit fair value measurements, but does not itself require any new fair value measurements.<sup>109</sup> FAS 157 became effective for nonfinancial assets and liabilities for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years.<sup>110</sup>

---

<sup>106</sup> SAB 99 cites the Supreme Court’s holding in *TSC*, *supra* note 3, 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.” SAB 99, *supra* note 4, at 45,151.

<sup>107</sup> *Id.* at 45,152.

<sup>108</sup> FAIR VALUE MEASUREMENTS, Statement of Financial Accounting Standards No. 157 (Financial Accounting Standards Bd. 2006) [hereinafter “FAS 157”].

<sup>109</sup> *Id.* at para. 2-3.

<sup>110</sup> FASB Staff Position 157-2, *Effective Date of FASB Statement No. 157* (Feb. 12, 2008). Note, however, that FAS 157 became effective for *financial* assets and liabilities for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

Under FAS 157, fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”.<sup>111</sup> With respect to measuring fair value, FAS 157 establishes a three-level hierarchy based on the types of “inputs” used, or the assumptions that market participants would use in pricing the asset or liability.<sup>112</sup>

- **Level 1 inputs** are quoted prices (unadjusted) in active markets for identical assets or liabilities that the company holding the asset or liability has the ability to access at the measurement date.<sup>113</sup> In general, level 1 inputs must be used to measure fair value whenever available.<sup>114</sup>
- **Level 2 inputs** are inputs other than quoted prices included in level 1 that are directly or indirectly “observable” for the asset or liability, such as a quoted price for a similar asset or liability in an active market.<sup>115</sup> FAS 157 defines “observable inputs” as those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the company holding the asset or liability.<sup>116</sup>
- **Level 3 inputs** are “unobservable inputs” for the asset or liability,<sup>117</sup> meaning they reflect the company’s own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best available information.<sup>118</sup> FAS 157 states that the best available information may include the company’s own data, but also indicates that the company must supplement its data with “information about market participant assumptions that is reasonably available without undue cost and effort”. The extent of this obligation is somewhat unclear, as the term “undue cost and effort” is not defined, though FAS 157 does emphasize that a company “need not undertake all possible efforts” to obtain further information.<sup>119</sup>

FAS 157 indicates that level 3 inputs should be used to measure fair value only to the extent that level 1 and level 2 inputs are not available.<sup>120</sup> Most environmental liabilities would be valued using level 3 inputs, since there are few active markets for such liabilities (required for level 1) and it would be difficult to develop pricing assumptions for unique, site-specific environmental liabilities based on market data alone (required for level 2).

FAS 157 also requires a number of disclosures regarding assets and liabilities measured at fair value, including: (i) the fair value measurements recorded and the reasons for such measurements; (ii) the

---

<sup>111</sup> FAS 157, *supra* note 108, at para. 5.

<sup>112</sup> *Id.* at para. 21.

<sup>113</sup> *Id.* at para. 24.

<sup>114</sup> *Id.*

<sup>115</sup> *Id.* at para. 28.

<sup>116</sup> *Id.* at para. 21.

<sup>117</sup> *Id.* at para. 30.

<sup>118</sup> *Id.* at para. 21.

<sup>119</sup> *Id.* at para. 30.

<sup>120</sup> *Id.*

level within the fair value hierarchy (1, 2 or 3) applicable to the fair value measurements; (iii) for fair value measurements using significant level 3 inputs, a description of those inputs and the information used to develop the inputs; and (iv) for annual periods only, the valuation techniques used to measure fair value and any changes to the valuation techniques used to measure similar assets or liabilities in previous periods.<sup>121</sup>

FAS 157 and fair value measurement generally have generated significant criticism in the legal community to the extent applied to nonfinancial liabilities, including environmental liabilities.<sup>122</sup> As indicated above, companies will need to generate assumptions about the assumptions market participants would use to value their environmental liabilities, which may be a difficult and subjective task. In addition, calculating fair value may require the use of sophisticated statistical techniques, such as probabilistic estimation or decision tree analysis, to take account of the numerous uncertainties inherent in environmental matters. For these reasons, FAS 157 may require companies to commit more time and resources to evaluating environmental liabilities that must be measured at fair value than they have in the past under FAS 5.<sup>123</sup>

The SEC has expressed strong support for fair value measurement, despite the criticism. In March and September 2008, the SEC sent two “Dear CFO” letters about fair value disclosures in the MD&A section to help focus senior management and audit committees on this issue.<sup>124</sup> The SEC is looking for more disclosure about the judgments and assumptions underlying a company’s fair value measurements, among other things. In addition, the SEC recently completed a study on fair value measurement (the “Fair Value Study”), which acknowledged that there have been some difficulties applying fair value standards, but emphasized that they should not be suspended.<sup>125</sup> While the Fair Value Study focused primarily on financial assets and liabilities in the context of market instability or inactivity, it generally recommended that FASB consider taking measures to improve FAS 157 and existing fair value requirements, particularly as they relate to level 2 and level 3 inputs. It is unclear at present exactly how FASB will respond to these recommendations, but the Fair Value Study may lead FASB to make changes that impact environmental accounting.

## *2. Financial Accounting Standard No. 143 and FASB Interpretation No. 47 – Asset Retirement Obligations*

In June 2001, FASB issued Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (“FAS 143”),<sup>126</sup> which it later clarified in March 2005 with FASB

---

<sup>121</sup> *Id.* at para. 32-33. Additional disclosures are required for assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (e.g., trading securities). *Id.* at para. 32.

<sup>122</sup> This criticism is not limited to the environmental context. Many lawyers are concerned about the application of fair value measurement to all types of litigation.

<sup>123</sup> It is not clear whether and to what extent the standards described in Section III.A apply to liabilities that must be measured at fair value according to FAS 157. To the extent there is a direct conflict between the provisions of FAS 157 and these earlier standards, the FAS 157 provisions most likely apply. If there is no direct conflict, a company may be required to apply the earlier standards as well.

<sup>124</sup> The March 2008 letter is available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>. The September 2008 letter is available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm>.

<sup>125</sup> *See supra* note 78.

<sup>126</sup> ACCOUNTING FOR ASSET RETIREMENT OBLIGATIONS, Statement of Financial Accounting Standards No. 143 (Financial Accounting Standards Bd. 2001) [hereinafter “FAS 143”].

Interpretation No. 47 (“FIN 47”).<sup>127</sup> FAS 143 applies to legal obligations associated with the retirement<sup>128</sup> of a tangible long-lived asset which obligations result from the acquisition, construction, development and/or normal operation of the asset.<sup>129</sup> A “legal obligation” is generally an obligation a party is required to settle as a result of a law or contract, such as a regulation that requires capping and closure and post-closure care of landfills.<sup>130</sup> An environmental remediation liability that results from the normal operation of a long-lived asset, such as spillage inherent in the normal operations of a fuel storage facility, would be subject to FAS 143. However, an environmental remediation liability that results from the improper operation of a long-lived asset, such as a catastrophic accident caused by noncompliance with a company’s safety procedures, does not fall within FAS 143, but would likely be subject to SOP 96-1.<sup>131</sup>

FAS 143 requires companies to recognize the fair value of a liability for an asset retirement obligation (“ARO”)<sup>132</sup> in the period in which the ARO is incurred if a reasonable estimate of fair value can be made. If a reasonable estimate of fair value cannot be made in the period in which the ARO is incurred, the liability must be recognized when a reasonable estimate of fair value can be made.<sup>133</sup> FIN 47 clarified that companies cannot wait to recognize the fair value of “conditional AROs” (i.e., legal obligations to perform activities when retiring assets where the timing or method of the retirement activities are *conditioned* on some future event that may or may not be within the control of the company<sup>134</sup>) until the date of retirement occurs or is definitively known. Instead, the fair value must be recognized when the legal obligation is incurred (or at such later time when a fair value estimate of the obligation can be made).

FIN 47 provides guidance regarding when a company has sufficient information to reasonably estimate the fair value of any ARO (conditional or not). The fair value of an ARO would be reasonably estimable if “(a) it is evident that the fair value of the obligation is embodied in the acquisition price of the asset, (b) an active market exists for the transfer of the obligation, or (c) sufficient information exists to apply an expected present value technique”.<sup>135</sup> A company would have sufficient information to apply an expected present value technique if either (i) the settlement date and method of settlement have been specified by others, e.g., by a law or contract or (ii) information is available to reasonably estimate (x) the settlement date or range of potential dates; (y) the actual or potential methods of settlement; and (z) the probabilities associated with the potential settlement dates and potential settlement methods.<sup>136</sup> FIN 47

---

<sup>127</sup> ACCOUNTING FOR CONDITIONAL ASSET RETIREMENT OBLIGATIONS: AN INTERPRETATION OF FASB STATEMENT NO. 143, Interpretation No. 47 (Financial Accounting Standards Bd. 2005) [hereinafter “FIN 47”].

<sup>128</sup> FAS 143 defines retirement as “the other-than-temporary removal of a long-lived asset from service”, including sale, abandonment, recycling or disposal in some other manner, but excluding the temporary idling of the asset. FAS 143, *supra* note 126, at para. 2 n.2.

<sup>129</sup> *Id.* at para. 2.

<sup>130</sup> *Id.* at para. A8. In June 2005, the FASB staff issued FASB Staff Position 143-1, *Accounting for Electronic Equipment Waste Obligations* (“FSP 143-1”), which addressed obligations imposed by Directive 2002/96/EC on Waste Electrical and Electronic Equipment (“WEEE”) adopted by the European Union. FSP 143-1 clarified that certain obligations relating to “historical” waste under WEEE should be accounted for as asset retirement obligations.

<sup>131</sup> FAS 143, *supra* note 126, at para. A13.

<sup>132</sup> An ARO is defined as an obligation associated with the retirement of a tangible long-lived asset. *Id.* at para. 1 n.1.

<sup>133</sup> *Id.* at para. 3.

<sup>134</sup> Examples of environmental conditional AROs include abating non-friable asbestos in a building, abandoning oil wells, decontaminating equipment and sealing pipelines.

<sup>135</sup> FIN 47, *supra* note 127, at para. 4 (footnotes omitted).

<sup>136</sup> *Id.* at para. 5.

then specifies the types of information that could provide a basis for estimating settlement dates and methods (and associated probabilities), including information derived from the company's past practice, industry practice, management's intent, or the asset's estimated economic life.<sup>137</sup>

Under FAS 143 and FIN 47, a company's financial statement footnotes must include:

- (i) a general description of the company's AROs and associated long-lived assets;
- (ii) the fair value of assets that are legally restricted for the purposes of settling AROs;
- (iii) a reconciliation of the beginning and ending aggregate carrying amount of AROs, which reconciliation separately shows the changes attributable to (a) liabilities incurred in the current period, (b) liabilities settled in the current period, (c) accretion expense and (d) revisions in estimated cash flows, if there is a significant change in one or more of the foregoing during the reporting period; and
- (iv) if the fair value of any ARO cannot be reasonably estimated, that fact and the reasons that prevent it from being estimated.<sup>138</sup>

The SEC has been monitoring compliance with FAS 143/FIN 47 requirements. In a number of comment letters, the SEC has asked companies about their application of FAS 143 and FIN 47, specifically asking companies to explain in detail why ARO fair values are not reasonably estimable.<sup>139</sup>

### 3. *FASB Interpretation No. 45 – Guarantees/Indemnities*

In November 2002, FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ("FIN 45").<sup>140</sup> FIN 45 clarified the requirements for recognizing, measuring and disclosing certain guarantees and indemnity obligations (collectively, "Guarantees"). Its provisions apply to Guarantees that have certain characteristics, including (i) contracts that require the guarantor to make payments or provide services to the guarantee based on another company's failure to perform under an obligating agreement and (ii) indemnities that require the indemnitor to pay the indemnified party based on changes in an "underlying" related to a liability of the indemnified party, such as an adverse judgment in a lawsuit.<sup>141</sup> "Underlying"

---

<sup>137</sup> *Id.*

<sup>138</sup> FAS 143, *supra* note 126, at para. 22; FIN 47, *supra* note 127, at para. 6.

<sup>139</sup> *See, e.g.*, Issuer Responses from Exxon Mobil Corp., to Jill S. Davis, SEC Branch Chief, at 6 (Nov. 9, 2006) (responding to SEC comment letter to Form 10-K for the fiscal year ended December 31, 2005, which comment letter stated, "In the event you believe asset retirement obligations cannot be reasonably estimated please expand your disclosures stating that fact and identify the reasons those obligations cannot be reasonably estimated"); Issuer Responses from Hess Corp., to Jill S. Davis, SEC Branch Chief, at 3 (Jan. 13, 2006) (responding to SEC comment letter to Form 10-K for the fiscal year ended December 31, 2004, which comment letter stated, "Please expand your disclosure to address how you account for asset retirement obligations that cannot be reasonably estimated. Additionally explain that is the case, if true, and the reasons it cannot be reasonably estimated").

<sup>140</sup> GUARANTOR'S ACCOUNTING AND DISCLOSURE REQUIREMENTS FOR GUARANTEES, INCLUDING INDIRECT GUARANTEES OF INDEBTEDNESS OF OTHERS: AN INTERPRETATION OF FASB STATEMENTS NO. 5, 57, AND 107 AND RESCISSION OF FASB INTERPRETATION NO. 34, FASB Interpretation No. 45 (Financial Accounting Standards Bd. 2002) [hereinafter "FIN 45"].

<sup>141</sup> *Id.* at para. 3.

is defined in relevant part to include any variable, as well as the “occurrence or nonoccurrence of a specified event”.<sup>142</sup> Various environmental Guarantees may fall within the scope of FIN 45.<sup>143</sup>

According to FASB, Guarantees obligate the guarantor in two respects. First, the guarantor undertakes “an obligation to stand ready to perform” in the event that the conditions specified in the Guarantee occur; this obligation is “noncontingent” and exists upon inception of the Guarantee.<sup>144</sup> Second, the guarantor undertakes a contingent obligation to make future payments if the conditions occur.<sup>145</sup> FIN 45 states that the noncontingent obligation must be recognized in the financial statements upon inception of the Guarantee, even if it is not probable that the specified conditions will occur and that payments will be made.<sup>146</sup> The noncontingent obligation must initially be measured at fair value, pursuant to FAS 157.<sup>147</sup> FASB indicated that guarantor may also be required to recognize a liability for the contingent obligation upon inception of the Guarantee (pursuant to FAS 5 if a liability is probable and reasonably estimable). If both the noncontingent and contingent obligations must be recognized at inception, FIN 45 indicates that the guarantor must recognize the greater of (i) the fair value of the noncontingent obligation or (ii) the amount required to be accrued for the contingent obligation pursuant to FAS 5.<sup>148</sup>

Under FIN 45, a guarantor must disclose various information, including the following, about each Guarantee or group of similar Guarantees, even if the likelihood of having to make any payments is remote.<sup>149</sup>

- (i) the nature of the Guarantee, including the approximate term, how it arose and the events or circumstances that would require the guarantor to perform;
- (ii) the maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the Guarantee (which may not be reduced by any potential future recovery) and if the guarantor cannot estimate this amount, the reasons why; and
- (iii) if applicable, the fact that there is no limitation on the guarantor’s maximum potential future payments.<sup>150</sup>

#### *4. Financial Accounting Standard No. 141R – Liability Recognition upon Business Combination*

---

<sup>142</sup> *Id.* at para. 3 n.2.

<sup>143</sup> FIN 45 specifically excludes certain Guarantees from some or all of its requirements, so a company must evaluate how to account for and disclose any particular Guarantee. For example, a parent’s Guarantee of its subsidiary’s debt to a third party and a subsidiary’s Guarantee of the debt owed to a third party by either its parent or another of the parent’s subsidiaries are subject to the disclosure requirements in FIN 45, but not the recognition and measurement rules. *Id.* at para. 7.

<sup>144</sup> *Id.* at para. 8.

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* at para. 9.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at para. 10. Note that FIN 45 focuses on initial recognition and measurement and does not describe subsequent measurement in detail. *Id.* at para. 12.

<sup>149</sup> FIN 45 does not define the term “remote”.

<sup>150</sup> FIN 45, *supra* note 140, at para. 13.

In December 2007, FASB issued a revised version of Statement of Financial Accounting Standards No. 141, *Business Combinations* (“FAS 141R”),<sup>151</sup> which governs how acquirers recognize and measure liabilities assumed in a business combination.<sup>152</sup> FAS 141R applies to business combinations closing on or after the beginning of the buyer’s first annual reporting period beginning on or after December 15, 2008 (so, for calendar year-end companies, acquisitions with a closing date of January 1, 2009 or later).<sup>153</sup>

Under the version of FAS 141R issued by FASB in 2007, the criteria for recognizing a contingency (and at what amount) turn on whether the contingency is contractual or noncontractual. A contractual contingency must be recognized at its fair value (calculated pursuant to FAS 157) as of the acquisition closing date, regardless of the probability of loss or whether the loss can be reasonably estimated.<sup>154</sup> A noncontractual contingency must be recognized at its fair value (calculated pursuant to FAS 157) as of the acquisition closing date if the acquirer determines that it is “more likely than not” that the contingency will give rise to a liability.<sup>155</sup> If the “more likely than not” standard is not met, however, the buyer instead accounts for the noncontractual contingency in accordance with other GAAP principles, including FAS 5. In addition, under the 2007 version of FAS 141R, companies must disclose in their footnotes the following information about liabilities arising from contingencies: (i) the amounts recognized at the acquisition date, or an explanation of why no amount was recognized; (ii) the nature of recognized and unrecognized contingencies; and (iii) an estimate of the range of outcomes (undiscounted) for recognized and unrecognized contingencies, or, if a range cannot be estimated, that fact and the reasons why.<sup>156</sup>

After issuance of FAS 141R, lawyers and other professionals raised various concerns about its provisions. In particular, they were concerned that FAS 141R would require lawyers to turn over privileged information to auditors to support the company’s decisions regarding recognition and measurement of loss contingencies, particularly pending lawsuits. FAS 141R’s disclosure rules could similarly require companies to reveal prejudicial information in the financial statement footnotes. Commentators also noted the difficulties inherent in determining the fair value of legal loss contingencies, especially in the early stages of disputes.

In response to these concerns, on December 15, 2008, FASB issued a proposed FASB Staff Position No. FAS 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies* (the “Proposed FSP”),<sup>157</sup> which, if adopted as written, would

---

<sup>151</sup> BUSINESS COMBINATIONS, Statement of Financial Accounting Standards No. 141 (revised 2007) (Financial Accounting Standards Bd.) [hereinafter “FAS 141R”].

<sup>152</sup> FAS 141R broadly defines business combination as “a transaction or other event in which an acquirer obtains control of one or more businesses” (including typical stock and asset purchases and mergers), subject to certain exceptions. *Id.* at para. 3.e.

<sup>153</sup> *Id.* at para. 74.

<sup>154</sup> *Id.* at para. 24.a.

<sup>155</sup> In its implementation guidance for FAS 141R, FASB explains that the “more likely than not” applies to whether the acquirer has incurred an obligation to pay if a specified event (the contingency) occurs—in other words, whether it is more likely than not that the company has a present obligation. *Id.* at para. A.63.

<sup>156</sup> *Id.* at para. 68.j. Buyers are allowed to aggregate disclosure of similar contingencies.

<sup>157</sup> ACCOUNTING FOR ASSETS ACQUIRED AND LIABILITIES ASSUMED IN A BUSINESS COMBINATION THAT ARISE FROM CONTINGENCIES, Proposed FASB Staff Position No. FAS 141(R)-a (Financial Accounting Standards Bd. 2008), available at [http://www.fasb.org/fasb\\_staff\\_positions/prop\\_fsp\\_fas141r-a.pdf](http://www.fasb.org/fasb_staff_positions/prop_fsp_fas141r-a.pdf) [hereinafter “Proposed FSP”].

amend FAS 141R significantly. The Proposed FSP would eliminate the distinction between contractual and noncontractual contingencies, which would eliminate the “more likely than not” standard for noncontractual contingencies. Under the Proposed FSP, a buyer would be required to recognize a liability arising from a contingency and assumed in a business combination if the acquisition-date fair value of such liability can be “reasonably determined” during the measurement period.<sup>158</sup> If this standard is met, the buyer must recognize and measure the liability at fair value according to FAS 157.<sup>159</sup>

The Proposed FSP describes two situations in which the fair value of a liability arising from a contingency is or may be “reasonably determinable”: (i) if a price for an identical or similar liability can be observed in the market place; and (ii) even if fair value cannot be estimated based on an observable market price, if sufficient information exists to apply a “valuation technique,” such as an income approach.<sup>160</sup> The Proposed FSP’s guidance on when sufficient information exists to apply a valuation technique is based on FIN 47. Specifically, under the Proposed FSP, a buyer would have sufficient information to apply an income approach (and therefore fair value would be reasonably determinable) if the available information allows the buyer to reasonably estimate: (a) the date the contingency will be resolved or a range of potential resolution dates; (b) the amount of future cash flows or a range of potential future cash flows; and (c) the probabilities associated with the potential resolution dates and future cash flows.<sup>161</sup> FASB acknowledged that companies often will not be able to reasonably determine the fair value of a liability arising from a “legal contingency”, particularly in the early stages of a dispute, but expected that sufficient information would be available to measure the fair value of “other liabilities” arising from contingencies, including some later-stage lawsuits.<sup>162</sup>

Under the Proposed FSP, if the fair value of a liability arising from a contingency cannot be reasonably determined, the buyer would be required to measure the liability “at the amount that would be recognized for liabilities in accordance with” FAS 5 and FIN 14 (the “future settlement amount”). The buyer would recognize the liability on its balance sheet as of the acquisition closing date if information available prior to the end of the measurement period indicates that (i) it is probable a liability had been incurred at the acquisition date and (ii) the future settlement amount can be reasonably estimated.<sup>163</sup>

The Proposed FSP would also amend FAS 141R’s footnote disclosure requirements. Under the Proposed FSP, a buyer would still have to disclose the following information with respect to liabilities

---

<sup>158</sup> *Id.* at para.7. The “measurement period” is a period of up to one year from the acquisition date. FAS 141R, *supra* note 151, at para. 51-52.

<sup>159</sup> Proposed FSP, *supra* note 157, at para. 8.

<sup>160</sup> *Id.* at para. 9. An “income approach” (as opposed to a market or cost approach) to determining fair value uses valuation techniques to convert future amounts to a single discounted present amount. Applicable valuation techniques include the present value technique and option-pricing models (e.g., the Black-Scholes-Merton formula). FAS 157, *supra* note 108, at para. 18.b.

<sup>161</sup> Proposed FSP, *supra* note 157, at para. 10. The Proposed FSP indicated that the buyer should have a “reasonable basis” for determining the probabilities in clause (c), but that even if it did not, the buyer “should still be able to reasonably determine the fair value when the potential timing and amount of future cash flows are so narrowly distributed that assigning probabilities without having a reasonable basis for doing so would not materially affect the fair value of the...liability”. *Id.* at para. 11.

<sup>162</sup> *Id.* at para. 13. The Proposed FSP does not define the term “legal contingency”, but does seem to use this term interchangeably with “legal dispute”. Accordingly, “legal contingency” could be narrowly construed to mean actual litigation only. The Proposed FSP also indicates that the shorter the time period in which the contingency will be settled or resolved, the more likely it is that the buyer will have sufficient information to reasonably determine fair value. *Id.* at para. 12.

<sup>163</sup> *Id.* at para. 14.

arising from contingencies recognized at the acquisition date: (i) the amounts recognized; (ii) the nature of the recognized contingencies; and (iii) an estimate of the range of outcomes (undiscounted) for recognized contingencies. In addition, a buyer would have to disclose the reasons why fair value could not be reasonably determined if a liability was not recognized at fair value.<sup>164</sup> The Proposed FSP, however, removes FAS 141R's requirement to disclose at the acquisition date the nature of, or an estimate of the range of outcomes for, *unrecognized* contingencies.

Comments on the Proposed FSP were due on January 15, 2009. FASB expects to issue a final FSP during the first quarter of 2009, the contents of which will apply retroactively to December 15, 2008. Until a final FSP is issued, companies must comply with FAS 141R as currently written.

### C. FASB Proposed Statement on FAS 5 and FAS 141R Loss Contingency Footnote Disclosure

Since at least the early 2000s, investors and users of financial information have expressed concerns over the adequacy of loss contingency disclosures in financial statements, raising concerns about whether they provide adequate information to assess the likelihood, timing and amount of future cash flows associated with those loss contingencies. In response to these concerns, FASB released in June 2008 an "Exposure Draft" for a proposed Statement of Financial Accounting Standards entitled *Disclosure of Certain Loss Contingencies—an amendment of FASB Statements No. 5 and 141(R)* (the "Proposed Statement").<sup>165</sup> This Proposed Statement would require greatly expanded footnote disclosure of environmental loss contingencies, including environmental remediation and environmental litigation liabilities, generally and in the context of business combinations.<sup>166</sup> As discussed in further detail below, FASB is currently reconsidering the Proposed Statement and has indicated that if it is adopted, it will not take effect until the end of 2009 at the earliest.

The Proposed Statement includes the following significant changes to footnote disclosure from current practice:<sup>167</sup>

- Expanded Population of Loss Contingencies Required to be Disclosed. Companies must disclose a loss contingency regardless of the likelihood of loss if (i) the contingency is expected to be resolved in the near term<sup>168</sup> and (ii) the contingency could have a "severe impact"<sup>169</sup> on the company's financial position, cash flows or results of operations.<sup>170</sup> Under

---

<sup>164</sup> *Id.* at para. 26. Buyers are allowed to aggregate disclosure of similar contingencies.

<sup>165</sup> DISCLOSURE OF CERTAIN LOSS CONTINGENCIES: AN AMENDMENT OF FASB STATEMENTS NO. 5 AND 141(R), Exposure Draft, Proposed Statement of Financial Accounting Standards (Financial Accounting Standards Bd. 2008), available at [http://www.fasb.org/draft/ed\\_contingencies.pdf](http://www.fasb.org/draft/ed_contingencies.pdf) [hereinafter "Proposed Statement"].

<sup>166</sup> The Proposed Statement does not, however, change the recognition and measurement guidance for loss contingencies contained in FAS 5 and FAS 141R and described above. *Id.* at para. A3.

<sup>167</sup> Note that disclosure of certain matters in the company's SEC filings may be required pursuant to Regulation S-K, even if not required in the footnotes pursuant to the Proposed Statement or existing FASB standards.

<sup>168</sup> The Proposed Statement uses the definition of "near term" from SOP 94-6: a period of time not to exceed one year from the date of the financial statements. Proposed Statement, *supra* note 165, at para. 6 n.1.

<sup>169</sup> This term also comes from SOP 94-6, which explains that "severe impact" means a significant financially disruptive effect on the normal functioning of an entity. It is a higher threshold than material, but less than catastrophic (e.g., bankruptcy). *Id.* at para. 6 n.2.

<sup>170</sup> *Id.* at para. 6.

the current version of FAS 5, remote loss contingencies (i.e., the likelihood of loss is slight) would not generally need to be disclosed.<sup>171</sup>

- Provision of More Quantitative Information. The disclosure of loss contingencies must include the amount of the claim or assessment against the company or, if there is no claim or assessment amount, the company's best estimate of the maximum exposure to loss. A company also may disclose its best estimate of the possible loss or range of loss if it believes that the amount of the claim or assessment or the maximum exposure to loss is not representative of its actual exposure.<sup>172</sup>
- Provision of More Qualitative Information. The disclosure must also include additional qualitative information about the loss contingency, including (i) a description of the contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution; (ii) a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome; (iii) the company's qualitative assessment of the most likely outcome of the contingency; (iv) significant assumptions made by the entity in estimating the amounts disclosed and in assessing the most likely outcome; and (v) the terms of relevant insurance or indemnification arrangements that could lead to a recovery of some or all of the possible loss, including any caps, limitations, or deductibles that could affect the amount of recovery.<sup>173</sup> FASB notes these disclosures may be aggregated by the nature of the loss contingency, e.g., environmental or product liability matters.<sup>174</sup>
- Tabular Reconciliation of Liabilities to Enhance Transparency. For each period for which a statement of income is presented, the footnotes must include a reconciliation, in tabular format, of the total amount recognized, in the aggregate, for loss contingencies at the beginning and end of the relevant period, with separate presentation of amounts recognized under FAS 5 and FAS 141R, respectively. The tabular reconciliation must include: (i) increases for loss contingencies recognized during the period; (ii) increases resulting from changes in estimates of the amounts of loss contingencies previously recognized; (iii) decreases resulting from changes in estimates or derecognition of loss contingencies previously recognized; and (iv) decreases resulting from cash payments (or other forms of settlement) for loss contingencies.<sup>175</sup> To support this table, a company must provide descriptions of significant activity in the reconciliation, as well as the total recovery amounts from insurance or indemnities related to these loss contingencies.<sup>176</sup>

FASB originally indicated that the Proposed Statement would be effective for annual financial statements issued for fiscal years ending after December 15, 2008 and interim and annual periods in

---

<sup>171</sup> FAS 5, *supra* note 77, at para. 3, 9.

<sup>172</sup> Proposed Statement, *supra* note 165, at para. 7.a.

<sup>173</sup> *Id.* at para. 7.b, c.

<sup>174</sup> This requirement may differ from what is required in the MD&A section. As discussed above in Section II.C, in 2006 the SEC advised companies to consider whether it is necessary to discuss loss contingencies in the MD&A section on both an aggregated and disaggregated basis.

<sup>175</sup> Proposed Statement, *supra* note 165, at para. 8.

<sup>176</sup> *Id.* at para. 8-9.

subsequent fiscal years. However, after receiving numerous comments on the Proposed Statement (including comments voicing the same concerns that were raised with respect to the loss contingency provisions of FAS 141R, i.e., enhanced disclosure would have a prejudicial effect on preparers and make auditing impractical), FASB has decided to prepare an “alternative model” for disclosure that will address the concerns raised by commenters. At this time, no details on substance of the alternative model are available.<sup>177</sup> FASB expects redeliberations on the Proposed Statement to begin in March or April 2009, and any new FASB statement on disclosure of loss contingencies would be effective no sooner than for fiscal years ending after December 15, 2009. Thus, until the Proposed Statement and alternative model have been fully vetted, companies will continue to prepare their environmental loss contingency footnote disclosure according to existing standards described earlier in this section.

#### IV. ENFORCEMENT OF ENVIRONMENTAL DISCLOSURE REQUIREMENTS

Sections 11 and 12 of the Securities Act and Section 10 of the Exchange Act (and, in particular, 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.<sup>178</sup>

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.<sup>179</sup> 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”.<sup>180</sup>

Most recently, SEC enforcement actions involving environmental disclosure have centered around allegedly improper accounting practices. In most of these actions, however, the improper environmental accounting was only a small part of a much larger fraudulent scheme.

The sections below describe SEC enforcement actions relating to environmental disclosure in periodic filings, including financial statement disclosure included in those periodic filings, and shareholder actions resulting in reported court decisions. In addition to enforcement of federal laws, there has been some enforcement of state securities laws in the climate change context, as discussed in Section V.D.

---

<sup>177</sup> The minutes of the September 24, 2008 FASB meeting discuss its plans with respect to the Proposed Statement. See [http://72.3.243.42/board\\_meeting\\_minutes/09-24-08\\_contingencies.pdf](http://72.3.243.42/board_meeting_minutes/09-24-08_contingencies.pdf).

<sup>178</sup> 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.

<sup>179</sup> See 1979 Interpretive Release, *supra* note 3, at 17,203-4-17, 203-5 n.11.

<sup>180</sup> *In re Occidental Petroleum Corp.*, Exchange Act Release No. 16,950, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,622, at 83,356, 1980 SEC LEXIS 1158 (July 2, 1980) (emphasis added) [hereinafter “*In re Occidental*”] (citing a variety of SEC releases).

## A. SEC Enforcement Actions Regarding Environmental Disclosure

### 1. SEC Enforcement Actions Regarding Environmental Disclosure Outside of the Financial Statements

The few SEC enforcement actions involving environmental disclosure in the narrative section of periodic filings (as opposed to the financial statements) have addressed several significant issues. First, these actions indicate that companies may, in certain situations, have to disclose environmental conditions or violations of environmental laws that have not yet been the subject of formal proceedings, but which could lead to liability. Second, generalized descriptions of potential environmental liability may be insufficient to inform investors properly. Finally, if companies choose to disclose their internal environmental policies, these disclosures must be accurate and not misleading.<sup>181</sup>

(i) *Allied Chemical Corporation.* In 1977, the SEC brought an enforcement 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 Kepone and other toxic chemicals into the environment.<sup>182</sup> 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.”<sup>183</sup> Thus, the SEC argued that Allied violated the disclosure rules when it did not disclose, in public announcements and in SEC filings, 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.<sup>184</sup>

(ii) *Occidental Petroleum Corporation.* In a similar 1980 enforcement action against Occidental Petroleum Corporation (“Oxy”),<sup>185</sup> the SEC charged that Oxy failed to disclose in the company’s annual and periodic reports 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.

---

<sup>181</sup> In the first three enforcement proceedings discussed in this Section IV.A.1 (Allied Chemical Corporation, Occidental Petroleum Corporation and United States Steel Corporation), the SEC alleged violations of both the general antifraud provisions and the then-current 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.

<sup>182</sup> See *SEC v. Allied Chem. Corp.*, Litigation Release No. 7811, 1977 SEC LEXIS 2280 (Mar. 4, 1977).

<sup>183</sup> *Id.*

<sup>184</sup> *Id.*

<sup>185</sup> *In re Occidental*, *supra* note 180. In anticipation of legal proceedings, this case ended with an Offer of Settlement submitted by Occidental to the SEC.

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.<sup>186</sup> 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 measures and monitoring activities be undertaken.<sup>187</sup> 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.<sup>188</sup>

(b) 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.<sup>189</sup>

(c) 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

---

<sup>186</sup> See *id.* at 83,351.

<sup>187</sup> See *id.* at 83,352.

<sup>188</sup> *Id.* (emphasis added).

<sup>189</sup> *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 *id.* at 83,353 n.22.

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 Falls municipal water treatment plant, Oxy should have disclosed its “potential liability” related to the S-Area Landfill.<sup>190</sup>

This action 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”.<sup>191</sup> 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.”<sup>192</sup>

(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 in the company’s Form 10-K its environmental policy of “actively resisting environmental requirements which it maintained were unreasonable. The Company minimized and delayed capital expenditures for environmental control”.<sup>193</sup> 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.”<sup>194</sup>

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.”<sup>195</sup> 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.

---

<sup>190</sup> *See id.* at 83,353.

<sup>191</sup> *Id.* at 83,351 (quoting Oxy’s Annual Report on Form 10-K for the period ending December 31, 1977).

<sup>192</sup> *Id.*

<sup>193</sup> *In re U.S. Steel*, *supra* note 6, at 82,380-81. In anticipation of legal proceedings, this case ended with an Offer of Settlement submitted by U.S. Steel to the SEC.

<sup>194</sup> *Id.* at 82,381 (quoting U.S. Steel’s filings with the SEC).

<sup>195</sup> *Id.* at 82,384 (quoting Securities Act Release No. 5627, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,719 (Oct. 14, 1975)).

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.<sup>196</sup>

(iv) *Lee Pharmaceuticals*. In a 1998 enforcement action against Lee Pharmaceuticals (“Lee”), the SEC asserted that Lee and members of its board had violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.<sup>197</sup> The SEC alleged that Lee had misrepresented and failed to adequately disclose a material 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:

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 [U.S.] 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.<sup>198</sup>

## 2. *SEC Enforcement Actions Regarding Environmental Disclosure in Financial Statements*

Between 2002 and 2007, the SEC brought at least four enforcement actions involving improper accounting for environmental matters. The defendants in these cases allegedly used environmental reserves to hide losses (environmental and otherwise) for which no reserves had been established and/or to inflate income, used non-environmental reserves to hide environmental losses and/or improperly capitalized certain environmental costs.

(i) *ConAgra*. In 2007, the SEC brought enforcement actions against ConAgra Foods, Inc. (“ConAgra”), a branded foods company, six former ConAgra executives and three senior executives at a

---

<sup>196</sup> *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 avoid rendering it misleading.

<sup>197</sup> *In re Lee Pharmaceuticals*, Exchange Act Release No. 39843, 1998 SEC LEXIS 691, at \*16-17 (April 9, 1998). In anticipation of legal proceedings, this case ended with an Offer of Settlement submitted by Lee to the SEC.

<sup>198</sup> *Id.* at 18-19.

ConAgra subsidiary.<sup>199</sup> The SEC alleged that ConAgra, a diversified international food company, engaged in improper and, in certain instances, fraudulent accounting practices during fiscal years 1999, 2000 and 2001, resulting in material misstatements of its net income and earnings per share, among other things.

While the SEC asserted a wide variety of improper accounting practices occurred at ConAgra, several of these practices related to the company's manipulation of its legal and environmental reserves. According to the SEC, ConAgra improperly maintained excess legal and environmental reserves, contrary to FAS 5 which requires a reserve to be removed when a liability is no longer probable and reasonably estimable. As of the end of fiscal year 2000, the reserves were potentially overstated by at least \$23.8 million. ConAgra allegedly used the excess reserves to offset \$5.4 million in unrelated, unplanned-for and unreserved-for losses resulting from a ConAgra frequent flier miles promotion. When ConAgra ultimately decided to reduce the excess legal and environmental reserves, it did so improperly, according to the SEC: rather than treating the removal of at least \$23.8 million of prior period excess reserves from its books as a correction of an error and reporting the correction as a prior period adjustment, ConAgra reduced two improperly maintained "general" reserve accounts.<sup>200</sup>

In addition, the SEC alleged that in fiscal year 1999, ConAgra improperly reallocated \$60 million from an excess tax reserve to cover unrelated, unplanned-for and unreserved-for exposures to legal and environmental matters. Without the reallocation of these reserves, ConAgra would have taken a \$60 million charge to income for legal and environmental expense without an offset for that charge.<sup>201</sup>

To settle the charges, ConAgra agreed to pay a \$45 million penalty and agreed to be permanently enjoined from violating the antifraud, reporting, books and records and internal controls provisions of the Exchange Act and rules promulgated thereunder. The SEC also entered into settlements with the former executives, which included disgorgement and payment of civil penalties.<sup>202</sup>

(ii) *Ashland*. In 2006, the SEC brought an administrative proceeding against Ashland Inc. ("Ashland"), a chemicals and petroleum company, and Ashland's Director of Environmental Remediation, William Olatin ("Olatin"). The parties settled pursuant to a cease and desist order dated November 29, 2006, which imposes no fines but requires Ashland to implement various, and potentially costly, internal controls.<sup>203</sup> The SEC alleged that Ashland, without any reasonable basis for doing so, reduced its cost estimates for its obligation to remediate environmental contamination at dozens of sites for which it was responsible. Reducing the estimates caused Ashland to materially understate its environmental reserve and overstate its net income in its SEC filings between 1999 and 2001. The SEC asserted that in doing so Ashland violated the reporting, books and records, and internal controls provisions of the Exchange Act,<sup>204</sup> and that Olatin caused Ashland's violations and violated Rule 13b2-1 of the Exchange Act.

---

<sup>199</sup> SEC v. ConAgra Foods, Inc., Litigation Release No. 20206, 2007 SEC LEXIS 1610 (July 25, 2007) [hereinafter "ConAgra Litigation Release"].

<sup>200</sup> Complaint, SEC v. ConAgra Foods, Inc., No. 07-cv-1557 (D. Colo. July 24, 2007).

<sup>201</sup> *Id.*

<sup>202</sup> ConAgra Litigation Release, *supra* note 199.

<sup>203</sup> *In re Ashland Inc.*, Exchange Act Release No. 54830, 2006 SEC LEXIS 2738 (Nov. 29, 2006) [hereinafter "*In re Ashland*"].

<sup>204</sup> Specifically, the SEC alleged violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and Rules 12b-20, 13a-1 and 13a-13 thereunder.

To determine Ashland's future environmental liability for environmental contamination, Olasin and his remediation team reviewed with an independent consultant remediation strategies for each of the contaminated chemical and refinery sites and then, using a computer program and certain manual corrections, estimated the cost ranges for each cleanup. Between 1999 and 2001, Olasin adjusted these cost estimates by between 10% and 41% without any reasonable basis or supporting documentation. The effect of these adjustments was to reduce Ashland's environmental reserve by as much as 7% and correspondingly increase the company's net income. The cease and desist order also details weaknesses in the relevant internal controls and how Ashland discovered and responded to Olasin's adjustments.

The SEC concluded that Ashland materially understated its environmental reserve and overstated its net income. It further determined that "Olasin had no reasonable basis for reducing these cost estimates" and that "Ashland's process for settling its environmental reserve did not establish adequate guidelines for, or require documentation or review of, adjustments to the costs estimates."<sup>205</sup>

(iii) *Waste Management*. In 2002, the SEC charged the founder and five other former top officers of Waste Management, Inc. ("Waste Management"), a waste disposal company, with engaging in a systematic scheme to falsify and misrepresent Waste Management's financial results from 1992 to 1997.<sup>206</sup> Five of the defendants ultimately settled with the SEC; under the terms of the settlements, the defendants were prohibited from serving as officers or directors of any public company and were required to pay more than \$31 million in disgorgement, prejudgment interest and civil penalties.<sup>207</sup> The remaining defendant was found liable on all the charges by a jury, was barred from acting as an officer or director of a public company and had to pay more than \$4 million in disgorgement, prejudgment interest and civil penalties.<sup>208</sup>

Waste Management's officers allegedly engaged in numerous improper accounting practices, which included manipulating the company's environmental reserves to improperly reduce current and future period operating expenses. According to the SEC, they charged certain unrelated operating expenses to previously established environmental reserves instead of expensing such costs out of current period income as required by GAAP, which had the effect of improperly reducing current period expenses and increasing income. The officers also reportedly misapplied purchase acquisition accounting principles relating to remediation liabilities by using inflated accruals established for newly acquired companies to offset under-accruals for liabilities for unrelated landfills. The SEC asserted that Waste Management failed to disclose in MD&A or elsewhere its arbitrary and improper accrual of remediation reserves through purchase acquisition accounting and ultimately avoided recording over \$100 million in current period expenses for environmental liabilities.<sup>209</sup>

In addition, Waste Management's officers allegedly improperly capitalized certain environmental expenses. Mountain Indemnity, Waste Management's wholly owned captive insurer, indemnified the company's operating units for landfill-related claims not covered by traditional insurance, such as property damage claims arising out of environmental contamination. Under GAAP, costs to repair or return property to its original condition, such as remediation costs, must generally be expensed when

---

<sup>205</sup> *In re Ashland*, *supra* note 203, at 2.

<sup>206</sup> SEC v. Buntrock, Litigation Release No. 17435, 2002 SEC LEXIS 736 (Mar. 26, 2002).

<sup>207</sup> SEC v. Buntrock, Litigation Release No. 18913, 2004 SEC LEXIS 2246 (Sept. 30, 2004); SEC v. Buntrock, Litigation Release No. 19351, 2005 SEC LEXIS 2198 (Aug. 29, 2005).

<sup>208</sup> Judgment, SEC v. Koenig, Civil Action No. 02-C-2180 (N.D. Ill. Dec. 21, 2007).

<sup>209</sup> Complaint, SEC v. Buntrock, Civil Action No. 02-C-2180 (N.D. Ill. Mar. 26, 2002).

incurred. Waste Management allegedly capitalized all claim costs submitted to Mountain Indemnity without analyzing whether capitalization was proper and amortized most capitalized claims over an arbitrary period, which resulted in inflated earnings.<sup>210</sup>

(iv) *Safety-Kleen*. In 2002, the SEC filed civil charges against Safety-Kleen Corp. (“Safety-Kleen”) and four of its former senior executives alleging they had perpetrated a massive accounting fraud from at least November 1998 through March 2000.<sup>211</sup> Separately, the U.S. Attorney’s Office for the Southern District of New York filed criminal charges against Safety-Kleen’s former Chief Financial Officer (“CFO”) and Controller.<sup>212</sup> Among other things, the executives allegedly created fictitious income by reducing several environmental remediation reserve accounts. The SEC asserted that these adjustments failed to comply with GAAP because they were made arbitrarily without any supporting analysis.<sup>213</sup>

Simultaneously with the filing of the complaint, Safety-Kleen consented to entry of a final judgment enjoining it from violating various sections of the Securities Act and Exchange Act and the rules promulgated thereunder.<sup>214</sup> Three of the individual defendants were barred from serving as an officer or director of a public company and were required to pay more than \$600,000 in disgorgement, prejudgment interest and civil penalties.<sup>215</sup> With respect to the criminal charges, the former CFO was sentenced to 70 months in prison, and the former Controller was sentenced to three years’ probation and a fine of approximately \$10,000.

#### 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*,<sup>216</sup> 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.<sup>217</sup> According to the lower court, information about the risks of MIC was not material for purposes of the federal securities laws.<sup>218</sup> 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

---

<sup>210</sup> *Id.*

<sup>211</sup> SEC v. Safety-Kleen Corp., Litigation Release No. 17891, 2002 SEC LEXIS 3169 (Dec. 12, 2002) [hereinafter “Safety-Kleen Litigation Release”].

<sup>212</sup> *Id.*

<sup>213</sup> Complaint, SEC v. Safety-Kleen Corp., No. 02-cv-9791 (S.D.N.Y. Dec. 12, 2002).

<sup>214</sup> Safety-Kleen Litigation Release, *supra* note 211.

<sup>215</sup> *Id.*; SEC v. Safety-Kleen Corp., Litigation Release No. 18555, 2004 SEC LEXIS 166 (Jan. 28, 2004).

<sup>216</sup> 648 F. Supp. 1322 (S.D.N.Y. 1986), *aff’d in part and modified in part*, *In re Union Carbide Corp. Gas Plant Disaster at Bhopal*, 809 F.2d 195 (2d Cir. 1987), *cert. denied*, 484 U.S. 871 (1987).

<sup>217</sup> *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.

<sup>218</sup> *See id.* at 1327.

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.<sup>219</sup>

The court stressed both that a materiality determination must be made from an *ex ante*, rather than an *ex post*, perspective,<sup>220</sup> and that the law should not encourage companies to “bury the shareholder in an avalanche of trivial information.”<sup>221</sup>

In *Levine v. NL Industries, Inc.*,<sup>222</sup> 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 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.<sup>223</sup>

A corporation is not required to disclose a fact “merely because a reasonable investor would very much like to know that fact”.<sup>224</sup> For example, in *Gannon v. Continental Insurance Company*, a stockholder made several claims against Continental Corporation (“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.<sup>225</sup> The plaintiff sought monetary and equitable relief for alleged violations of Rule 10b-5.

---

<sup>219</sup> *Id.*

<sup>220</sup> *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*.”)

<sup>221</sup> *Union Carbide*, 648 F. Supp. at 1327 (quoting *TSC*, *supra* note 3).

<sup>222</sup> 926 F.2d 199 (2d Cir. 1991).

<sup>223</sup> *Id.* at 203 (citations omitted).

<sup>224</sup> *In re Time Warner, Inc. Securities Litigation*, 9 F.3d 259, 267 (2d Cir. 1993).

<sup>225</sup> 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.” *Id.* at 577.

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.<sup>226</sup>

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*,<sup>227</sup> AES Corporation ("AES") 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.<sup>228</sup>

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

---

<sup>226</sup> *Id.* at 580.

<sup>227</sup> 825 F. Supp. 578 (S.D.N.Y. 1993).

<sup>228</sup> *Id.* at 588-89.

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 prove that AES did intend to defraud investors in violation of Rule 10b-5.<sup>229</sup> We do not have any information regarding the ultimate outcome of this matter.

## V. DISCLOSURE OF CLIMATE CHANGE RISKS

Certain investors, politicians and environmental groups have alleged, both formally and informally, that companies are not adequately disclosing climate change risks in their SEC filings. To date, the SEC has not responded to these concerns, and has in fact seemed to indicate that it does not intend to do so. One state attorney general has, however, used state securities laws successfully to force certain power companies to increase the scope of their SEC climate change disclosure.

While it is currently unclear for many companies precisely whether, how or when climate change issues will materially adversely affect them, it is clear that every public company must consider its risk profile in light of known and potential future developments, and must in turn consider whether additional or different disclosure is necessary in its SEC filings. Companies must also ensure that information in their disclosure is consistent with information provided outside of their SEC filings, such as on their websites, in sustainability reports and to nongovernmental organizations.<sup>230</sup> This will be an ongoing process for most companies, as laws develop (or stall) during this uncertain economic time, and as companies further develop views as to how climate change may impact them, which may include incurring extra costs to comply with new regulations or dealing with the physical impacts (e.g., rising sea level) of a changing climate.

This section describes (i) the current state of climate change law and potential near-term developments, (ii) whether and how existing SEC disclosure requirements affect the consideration of climate change risks, (iii) some of the formal appeals, shareholder proposals, congressional inquiries and bills relating to climate change disclosure, (iv) subpoenas issued by the New York State Attorney General (the "NY Attorney General") alleging inadequate climate change disclosure and (v) some proposed climate change disclosure frameworks.

### A. *Current Regulation of Climate Change*

A variety of different regulatory regimes have been implemented and proposed to address the global challenges posed by climate change. While it is beyond the scope of this memorandum to outline all of these regimes—many of which are at the local level—the more significant climate change regulations include the following:

- **International.** Over 180 countries (not including the U.S.) have ratified the Kyoto Protocol to the United Nations Framework Convention on Climate Change. The Kyoto Protocol includes binding emissions targets for the developed countries that ratify it, with the aim of

---

<sup>229</sup> *Id.* at 589. Under the current securities laws, as amended by the Sarbanes-Oxley Act of 2002, 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.

<sup>230</sup> For example, companies may provided detailed data to the Carbon Disclosure Project ("CDP"). CDP, founded in the U.K. in 2000, submits an annual questionnaire to major corporations around the world about these companies' greenhouse gas emissions and climate change-related risks and then publishes reports describing the responses. In 2008, 77% of the Global 500 (FTSE Global Equity Index Series) and 64% of the S&P 500 completed the CDP's questionnaire. Carbon Disclosure Project, CDP 2008 Quick Facts, available at <http://www.cdproject.net/reports.asp>.

reducing these countries' greenhouse gas ("GHG") emissions by approximately 5% below 1990 levels. It also includes market-based mechanisms for achieving these reductions, including a cap-and-trade program and programs for generating carbon credits (called the Clean Development Mechanism and Joint Implementation).

- **European Union.** The European Union's Greenhouse Gas Emissions Trading Scheme (the "ETS") has been operating since January 2005. The ETS is the world's largest GHG cap-and-trade program. Facilities subject to the ETS, such as power plants and cement factories, must meet government-imposed emissions limits. If a facility's GHG emissions are below the limit, it may sell government-granted emissions "allowances" to other parties. However, if its emissions exceed the limit, it must purchase allowances or pay a steep penalty.
- **Federal U.S.** As discussed in Section V.C.2 below, several climate change bills were introduced in the 110<sup>th</sup> Congress, but none were ultimately adopted.<sup>231</sup> President Obama has expressed his support for aggressive federal climate change legislation, including a nationwide cap-and-trade program. Nevertheless, because of the country's economic difficulties, there is a great deal of uncertainty as to whether any climate change legislation will be adopted in the near term.
- **Regional and State U.S.** In the absence of federal action, numerous states have begun regulating GHG emissions. For example, California, a leader in this area, has adopted a wide-ranging plan to reduce the state's GHG emissions to 1990 levels by 2020. In addition, three regional cooperatives—the Regional Greenhouse Gas Initiative in the Northeast, the Midwestern Greenhouse Gas Reduction Accord and the Western Climate Initiative—have established or plan to establish cap-and-trade programs.

#### B. *Existing Disclosure Requirements*

Pursuant to existing disclosure requirements in Regulation S-K<sup>232</sup> and accounting guidance, companies may be required to disclose a variety of climate change matters, including:

- **Item 101—Business.** Material capital or operating costs incurred to comply with climate change regulations, such as purchasing emissions allowances, paying carbon taxes or installing new technology to reduce GHG emissions.
- **Item 103—Legal Proceedings.** Legal proceedings to which a company or its properties are involved related to or involving climate change which are (i) material, (ii) involve amounts greater than 10% of current consolidated assets or (iii) involve monetary sanctions of \$100,000 or more, such as lawsuits brought against the company by public interest groups or proceedings relating to the receipt of key air permits.
- **Item 303—MD&A.** Known trends, demands, commitments, events or uncertainties related to climate change, unless the company can conclude that the trends, demands, commitments, events or uncertainties (i) are not "reasonably likely" to occur or (ii) assuming they will come

---

<sup>231</sup> Though there is currently no federal law *directly* addressing climate change, the U.S. Supreme Court has indicated that the EPA has authority to regulate carbon dioxide under the federal Clean Air Act. *See generally* Massachusetts v. EPA, 549 U.S. 497 (2007).

<sup>232</sup> Please see Section II for a detailed discussion of these requirements.

to fruition, are not “reasonably likely” to have a material effect on the company’s liquidity, capital resources or results of operations.<sup>233</sup> Climate change is arguably a known “uncertainty” and as such, its material physical impacts on a company would need to be disclosed in the MD&A section. Similarly, depending on the circumstances, proposed climate change regulation may also be a known “uncertainty” that must be disclosed.<sup>234</sup> Companies may want to evaluate these issues with particular care, as the SEC has recently focused on the perceived inadequacies in MD&A disclosure generally.

- **Item 503(c)—Risk Factors.** Significant risks affecting the company or the securities it offers to the public, including the regulatory and litigation risks described above, as well as reduced demand for certain products or public outcry against certain companies because of their climate impact (e.g., coal-fired power plants).
- **FAS 5—Financial Statements.** Material loss contingencies that are more than remote,<sup>235</sup> such as physical impacts on the company from the changing environment (e.g., rising sea levels or potential water shortages).

While the existing SEC disclosure rules do not per se require companies to collect additional information to assess their climate change risks, companies clearly need to be collecting whatever information or doing whatever research is required to comply with the actual climate change laws to which they are subject. For example, certain companies or industries are currently required to measure their GHG emissions while others are not. For those companies that are not currently subject to these laws, these companies should, at a minimum, stay abreast of applicable or relevant laws and litigation (even if they are not a party) and carefully track any facts required to determine whether climate change risks are material to them.<sup>236</sup>

### C. *Calls for Guidance on Climate Change Disclosure*

#### 1. *Ceres Petition to the SEC and Other Shareholder Efforts*

Over the past year and a half, investors and investor groups, primarily lead by Ceres,<sup>237</sup> have increasingly pressured the SEC to address climate change disclosure in companies’ mandatory public filings. On September 18, 2007, a twenty-two member coalition consisting of Ceres, Environmental Defense, the NY Attorney General, state treasurers and comptrollers, pension fund managers and others petitioned the SEC to provide interpretative guidance on climate risk disclosure (the “Ceres Petition”).<sup>238</sup>

---

<sup>233</sup> MD&A Release, *supra* note 40, at 62,843.

<sup>234</sup> For example, MD&A Release notes that a company would have to disclose regulations proposed pursuant to adopted legislation that, if promulgated, would require the company to incur material capital expenditures. *Id.*

<sup>235</sup> In addition, companies must make an accrual for any material loss contingencies that are probable and reasonably estimable, as discussed in Section III.A.1.

<sup>236</sup> Federal law requires the EPA to develop a mandatory greenhouse gas emissions reporting system. The EPA is currently in the process of drafting a proposed rule to establish this system, which rule it expects to issue for comment in early spring 2009.

<sup>237</sup> Ceres is a coalition of investors, environmentalists and public interest groups that aims to improve corporate environmental and social performance. Its members include a number of large state pension funds, including the California Public Employees Retirement System, and state treasuries. See Ceres Coalition, <http://www.ceres.org/Page.aspx?pid=425>.

<sup>238</sup> Petition for Interpretive Guidance on Climate Risk Disclosure, Sept. 18, 2007, <http://www.incr.com/Document.Doc?id=187>.

The Ceres Petition asks the SEC to issue guidance in the form of an interpretative release: (i) clarifying that, under existing law, companies must assess the implications of climate change on their financial condition and operations; (ii) setting forth the process by which companies should make this assessment; and (iii) directing companies to disclose the physical risks associated with climate change, the financial risks associated with present or probable regulation of GHG emissions and legal proceedings related to climate change, if any of such risks or proceedings are material.

Since September 2007, Ceres and others have continued to press the SEC through various means, including the following:

- On May 20, 2008, Ceres, through its Investors Network on Climate Risk, and a group of more than fifty leading investors sent a letter to Senate Majority Leader Harry Reid and Minority Leader Mitch McConnell requesting that the senators press the SEC to issue guidance on climate change disclosure or include disclosure provisions in comprehensive climate change legislation.<sup>239</sup>
- On June 12, 2008, Ceres made a supplemental filing to the SEC that described relevant developments since the original Ceres Petition (including legislative, regulatory and litigation developments and studies indicating the need for improved disclosure) and reiterated its request for interpretive guidance.<sup>240</sup>
- On September 8, 2008, Ceres and a group of institutional investors submitted comments on a proposed SEC rule regarding oil and gas reserve disclosure, calling for the SEC to require disclosure of the carbon content of proven, probable and potential reserves, as well as the potential liabilities posed by their continued extraction and use.<sup>241</sup>
- On October 22, 2008, Ceres (through its Investors Network on Climate Risk) and representatives of 13 state and city treasuries, public pension funds, asset managers and large institutional investors submitted a letter to the SEC in connection with the SEC's "21<sup>st</sup> Century Disclosure Initiative" reiterating the call for "consistent, comparable standards for disclosure of climate risk information".<sup>242</sup>

To date, the SEC has not issued the requested interpretive guidance or otherwise officially responded to the Ceres Petition or the letters described above.<sup>243</sup>

---

<sup>239</sup> See Ceres, *Investors Managing \$2.3 Trillion Call on Congress to Tackle Global Climate Change*, May 20, 2008, <http://www.ceres.org/Page.aspx?pid=899>.

<sup>240</sup> Letter from California Public Employees' Retirement System et al., to Nancy M. Morris, SEC Sec'y (June 12, 2008), available at <http://www.ceres.org/Document.Doc?id=358>.

<sup>241</sup> See Ceres, *Investors Call on SEC to Expand Climate Reporting Requirements to Include Oil Sands*, Sept. 9, 2008, <http://www.ceres.org/Page.aspx?pid=941>. On December 31, 2008, the SEC issued its final rule, effective January 1, 2010, revising its oil and gas reporting disclosures. The final rule did not incorporate the comments submitted by Ceres and the group of institutional investors.

<sup>242</sup> See Ceres, *Investors Call on SEC to Require Better Disclosure on Climate Change and Other Risks*, Oct. 23, 2008, <http://www.ceres.org/Page.aspx?pid=951>. In addition to addressing climate change, this letter called on the SEC to consider how material environmental, social and corporate governance data can be integrated into public filings.

<sup>243</sup> Note that not all of the petitions to the SEC have been from the political left. The Free Enterprise Action Fund, an activist conservative mutual fund, has petitioned the SEC on at least two occasions requesting interpretive guidance on disclosing business risks associated with climate change regulation and company lobbying efforts in favor of such regulation. Petition for (...continued)

Various pension funds have, either individually or through investor groups such as Ceres, emphasized the importance of climate change disclosure. For example, the corporate governance policy adopted by the California Public Employees' Retirement System indicates companies should provide "accurate and timely disclosure" of climate change risks.<sup>244</sup>

## 2. Congressional Activity

Some members of Congress have also shown an interest in disclosure of climate change risks in SEC filings. On October 31, 2007, a Senate subcommittee held a hearing on "Climate Change: Measuring Financial Risks and Opportunities" to assess the types of risks and opportunities presented by climate change, how these are disclosed in SEC filings and the adequacy of current disclosure requirements. Subsequently, in December 2007, Senator Christopher Dodd, Chairman of the Committee on Banking, Housing and Urban Affairs, and Senator Jack Reed, Chairman of the Subcommittee on Securities, Insurance and Investment, sent a letter to SEC Chairman Christopher Cox requesting that the SEC issue interpretive guidance clarifying what existing regulations require with respect to climate change disclosure.<sup>245</sup> While the senators did not call for any new rules, some of their requests appeared to go beyond simply interpreting the existing regulations and instead would have required additional analysis and disclosures.<sup>246</sup> The SEC has not acted on this request.

A number of the climate change bills previously introduced in the U.S. Congress have contained SEC disclosure requirements. In October 2007, Senators Lieberman and Warner introduced "America's Climate Security Act" (the "Lieberman-Warner Bill")<sup>247</sup>, which would have established a comprehensive cap-and-trade program to reduce GHG emissions. While the Lieberman-Warner Bill failed, the version initially introduced to committee included several climate change disclosure provisions that would have required the SEC to:

- promulgate regulations directing each issuer of securities under the Exchange Act to disclose "material risks relating to . . . (1) the financial exposure of the issuer because of the net global warming pollution emissions of the issuer; and (2) the potential economic impacts of global warming on the interests of the issuer";<sup>248</sup>

---

(continued...)

Interpretive Guidance on Business Risk of Global Warming Regulation, Oct. 22, 2007, <http://www.sec.gov/rules/petitions/2007/petn4-549.pdf>; see also Petition for Interpretive Guidance on Public Statements Concerning Global Warming and Other Environmental Issues, July 21, 2008, <http://www.sec.gov/rules/petitions/2008/petn4-563.pdf>.

<sup>244</sup> The California Public Employees' Retirement System, *Global Principles of Accountable Corporate Governance* (last updated Aug. 18, 2008), available at <http://www.calpers-governance.org/principles/docs/2008-8-18-global-principles-accountable-corp-gov-final.pdf>.

<sup>245</sup> Letter from Christopher J. Dodd and Jack Reed, U.S. Senators, to Christopher Cox, SEC Chairman (Dec. 6, 2007), available at [http://dodd.senate.gov/multimedia/2007/120607\\_CoxLetter.pdf](http://dodd.senate.gov/multimedia/2007/120607_CoxLetter.pdf).

<sup>246</sup> For example, the proposed interpretive guidance should "clarify that registrants should assess the consequences of climate change and existing and anticipated future governmental regulation of greenhouse gas emissions on their business, results of operations, and financial condition, or should disclose their basis for determining that such an assessment is not warranted" and "provide guidelines and criteria for use by registrants in conducting such an assessment, including on accounting and auditing standards that registrants and their auditors should consider in evaluating a climate change assessment". *Id.*

<sup>247</sup> America's Climate Security Act of 2007, S. 2191, as introduced on October 18, 2007.

<sup>248</sup> *Id.* at § 9002(a).

---

*This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal or accounting advice.*

- issue an interim interpretive release clarifying that, under Items 101 and 303 of Regulation S-K, the commitments of the U.S. under the United Nations Framework Convention on Climate Change to reduce GHG emissions are a “material effect” and that global warming is a “known trend”,<sup>249</sup> and
- work with FASB (or “another appropriate organization that establishes voluntary standards”) to develop a uniform format for disclosing the risks described above.<sup>250</sup>

Several other climate bills introduced (but not enacted) in the 110<sup>th</sup> Congress—including the Greenhouse Gas Accountability Act of 2007,<sup>251</sup> Global Warming Reduction Act of 2007<sup>252</sup> and Global Warming Pollution Reduction Act<sup>253</sup>—contained similar or identical provisions.

On July 14, 2008, the U.S. Senate Committee on Appropriations issued a report on the 2009 appropriations bill, which included the following language: “The Committee is aware that a petition was filed with the [SEC] on September 18, 2007, calling for the issuance of an interpretive release clarifying the application of existing law to the disclosure of risks associated with climate change. The [SEC] is encouraged to give prompt consideration to this petition and to provide guidance on the appropriate disclosure of climate risk”.<sup>254</sup>

It is difficult to predict whether climate change disclosure will be addressed in any climate change legislation ultimately adopted by the 111<sup>th</sup> (or any subsequent) Congress. For example, one recently proposed bill, the Dingell-Boucher Bill introduced in October 2008,<sup>255</sup> does not specifically mention climate change disclosure. Furthermore, President Obama has not indicated his position on climate change disclosure in SEC filings.

#### *D. New York Subpoenas Regarding Climate Change Disclosure*

While the calls for better climate change disclosure and new and improved disclosure requirements have not yet resulted in SEC guidance, at least one state has taken action on the issue. On September 14, 2007, in an effort to underscore the Ceres Petition to which he was a signatory, the NY Attorney General, Andrew M. Cuomo, issued subpoenas to five companies questioning the sufficiency of their climate change disclosure under the New York State securities statute.<sup>256</sup> The subpoenas, along with

---

<sup>249</sup> *Id.* at § 9002(c). This interim interpretive release would only be effective until the SEC promulgated the regulations described in the prior bullet. *Id.*

<sup>250</sup> *Id.* at § 9002(b).

<sup>251</sup> Greenhouse Gas Accountability Act of 2007, H.R. 2651, § 6 (introduced by Representative Engel on June 11, 2007).

<sup>252</sup> Global Warming Reduction Act of 2007, S. 485, § 302 (introduced by Senators Kerry and Snowe on February 1, 2007).

<sup>253</sup> Global Warming Pollution Reduction Act, S. 309, § 9 (introduced by Senators Sanders and Boxer on January 16, 2007).

<sup>254</sup> S. REP. NO. 110-417, at 108, Financial Services and General Government Appropriations Bill, 2009 (2008).

<sup>255</sup> Discussion Draft, Referred to U.S. House of Representatives Committee on Energy and Commerce (introduced by Representatives Boucher and Dingell on October 7, 2008), available at [http://energycommerce.house.gov/images/stories/Documents/PDF/selected\\_legislation/clim08\\_001\\_xml.pdf](http://energycommerce.house.gov/images/stories/Documents/PDF/selected_legislation/clim08_001_xml.pdf).

<sup>256</sup> The NY Attorney General relied on N.Y. Gen. Bus. Law § 352, commonly referred to as the Martin Act, as the source of the authority for the subpoenas. The Martin Act allows investigation of any “fraudulent practice” related to investments.

letters from the NY Attorney General's office, were sent to four power companies—AES Corporation, Dominion Resources Inc., Dynegy Inc. (“Dynegy”) and Xcel Energy Inc. (“Xcel”)—and a coal producer, Peabody Energy Corp.

According to the NY Attorney General, the companies are subject to “increased climate risks” as a result of their business operations and, in some cases, their plans to construct additional coal-fired power plants, which risks may not have been adequately disclosed in their prior SEC filings. The NY Attorney General specifically noted that the companies’ 2006 10-Ks did not include: (i) projected carbon dioxide emissions from existing or proposed power plants; (ii) any attempt to evaluate or quantify the possible effects of future GHG regulations, or a discussion of their impact on the company; and/or (iii) any strategies to reduce carbon dioxide emissions (as new regulations would likely require).

In August and October 2008, respectively, two of these companies, Xcel and Dynegy, reached settlements with the NY Attorney General, pursuant to which each company agreed to provide more detailed climate change disclosure in their future SEC Annual Reports on Form 10-K, including descriptions of:

- Financial Risks from Regulation. The material financial risks to the company associated with present and probable legislation and regulations relating to GHG emissions;
- Financial Risks from Litigation. Any material climate change litigation involving the company, as well as any decisions relating to climate change issued by the U.S. Supreme Court, any U.S. Court of Appeals or any court in any jurisdiction in which the company operates that may<sup>257</sup> have a material financial effect on its business;
- Financial Risks from Physical Impacts. The material financial risks to the company’s operations from the physical impacts associated with climate change, such as changes in sea level, weather, precipitation and temperature; and
- Strategic Analysis of Risk. To the extent the company’s GHG emissions materially affect its financial exposure from climate risk, the company’s current position on climate change, certain GHG emissions data, strategies to reduce climate change risks and the results of those strategies and corporate governance measures related to climate change.<sup>258</sup>

Though the Xcel and Dynegy settlements may not necessarily represent binding interpretations of what is required under the federal securities laws, as a practical matter, they may provide other companies with a starting point of issues to consider when drafting their own climate change disclosure.

---

<sup>257</sup> The Dynegy settlement substitutes the words “are likely to” for “may”.

<sup>258</sup> See *In re Xcel Energy Inc.*, Assurance of Discontinuance Pursuant to Executive Law § 63(15), AOD #08-012 (Aug. 26, 2008), available at [http://www.oag.state.ny.us/media\\_center/2008/aug/xcel\\_aod.pdf](http://www.oag.state.ny.us/media_center/2008/aug/xcel_aod.pdf); *In re Dynegy Inc.*, Assurance of Discontinuance Pursuant to Executive Law § 63(15), AOD #08-132 (Oct. 23, 2008), available at [http://www.oag.state.ny.us/media\\_center/2008/oct/dynegy\\_aod.pdf](http://www.oag.state.ny.us/media_center/2008/oct/dynegy_aod.pdf). In addition to the settlement, Dynegy also recently agreed to prepare a report on the feasibility of adopting specific greenhouse gas reduction goals for its existing and proposed power plants in response to a shareholder proposal.

## E. *Additional Frameworks for Disclosure*

As noted above, the Ceres Petition, the Senators Dodd and Reed letter to the SEC and the Xcel and Dynegy NY Attorney General settlements all lay out various matters that companies may choose to or may ultimately need to evaluate when preparing their SEC filings. In addition, other organizations have proposed alternative frameworks for voluntary climate change disclosure<sup>259</sup>:

- 2006 Global Framework for Climate Risk Disclosure (the “Global Framework”).<sup>260</sup> The Global Framework was released in October 2006 by a group of leading institutional investors and investor groups led by Ceres. It encourages companies to disclose voluntarily: (i) their total historical, current and projected GHG emissions; (ii) their strategic analysis of climate risk and emissions management; (iii) their assessment of the physical risks of climate change; and (iv) their analysis of risk related to the regulation of GHG emissions. Note that the Global Framework does not suggest that all of these matters need to be disclosed in a company’s SEC filings; rather, they may be disclosed through other means, such as the Carbon Disclosure Project or sustainability reports.
- 2008 ASTM Draft Guide for Disclosures Related to Climate Change Exposures/Risks. ASTM International (“ASTM”), a standards-setting organization, is currently developing voluntary guidelines that aim to “provide a series of options or instructions consistent with good commercial and customary practice for climate change-related disclosures accompanying audited and unaudited financial statements”.<sup>261</sup> In late 2008, ASTM released to a limited audience for review a draft standard.<sup>262</sup> It estimates a final standard will not be available until after June 2009 at the earliest.

## VI. SOME PRACTICAL CONSIDERATIONS

A reporting company’s environmental disclosure must be correct and adequate, but determining what a company must do meet that standard is difficult and the myriad issues to consider are subject to significant and rapidly developing changes. This section sets forth a few practical measures a company may consider implementing to comply with the SEC and accounting standards outlined in this memorandum.

### A. *General*

- Consider charging a set group of employees and/or officers with responsibility for environmental data collection, compliance with related SEC disclosure obligations and

---

<sup>259</sup> The need for guidance on climate change disclosure is not limited to the U.S. For example, in late 2008, the Canadian Institute of Chartered Accountants issued a document entitled, *Building A Better MD&A: Climate Change Disclosures*, to help Canadian filers better disclose the business impacts of climate change to investors. CANADIAN PERFORMANCE REPORTING BOARD, BUILDING A BETTER MD&A: CLIMATE CHANGE DISCLOSURES (2008), available at [http://www.cica.ca/download.cfm?ci\\_id=48027&la\\_id=1&re\\_id=0](http://www.cica.ca/download.cfm?ci_id=48027&la_id=1&re_id=0)

<sup>260</sup> CLIMATE RISK DISCLOSURE INITIATIVE, GLOBAL FRAMEWORK FOR CLIMATE RISK DISCLOSURE (2006), available at [http://www.unepfi.org/fileadmin/documents/global\\_framework.pdf](http://www.unepfi.org/fileadmin/documents/global_framework.pdf).

<sup>261</sup> See ASTM WK21096-New Guide for Disclosures Related to Climate Change Exposures/Risks, <http://www.astm.org/DATABASE.CART/WORKITEMS/WK21096.htm>.

<sup>262</sup> The draft guidelines are not posted on ASTM’s website, but ASTM will provide copies upon request. For contact information, see *id.*

---

*This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal or accounting advice.*

- periodic evaluation of disclosure controls aimed at identifying environmental costs and liabilities.
- ❑ Confirm that the disclosure, financial statements and information presented to the SEC, EPA and other environmental agencies do not conflict with any environmental information the company has voluntarily disclosed.
  - ❑ Periodically cross-check the company's environmental disclosure against Section I.B of this memorandum.
  - ❑ Avoid "greenwashing" in SEC filings, i.e., avoid disclosure that overestimates or otherwise may mislead investors regarding actual or alleged positive environmental practices of the company or the environmental benefits of its products or services.
  - ❑ With respect to the MD&A section specifically:
    - ❑ Consider all financial and nonfinancial information available to the company when identifying known material environmental trends and uncertainties and whether the available information itself is required to be disclosed. (According to the SEC, "[t]his information, over time, may reveal a trend or general pattern in activity, a departure or isolated variance from an established trend, an uncertainty, or a reasonable likelihood of the occurrence of such an event that should be disclosed".)<sup>263</sup>
    - ❑ Review the MD&A disclosure against the financial statement footnotes, both of which will likely be revised periodically due to changes in accounting rules described in Section III.

*B. Environmental Accounting*

- ❑ When evaluating an environmental liability, first consider under which of four general categories of environmental liabilities the liability falls, and then apply the corresponding rules. As set out in Section III:
  - ❑ Environmental AROs → FAS 143, FIN 47, FAS 157.
  - ❑ Environmental Guarantees → FAS 5, FIN 45 and FAS 157.
  - ❑ Environmental Liabilities Acquired in a Business Combination → FAS 141R/FSP 141R-a, FAS 157 and related Proposed Statement/Alternative Model.
  - ❑ Other Environmental Liabilities → FAS 5, related Proposed Statement/Alternative Model, and FIN 14, SAB 92, SOP 94-6 and SOP 96-1.
- ❑ Develop and document accounting procedures for each of the four categories of loss contingencies, including detailing:

---

<sup>263</sup> SEC, Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, available at <http://www.sec.gov/rules/interp/33-8350.htm>.

- ❑ the rationale for booking or not booking a reserve;
  - ❑ how reserves were calculated;
  - ❑ if any environmental AROs, guarantees or business combination liabilities were not measured at fair value, the rationale as to why they were not (with specific notes as to what data would be required to calculate fair value); and
  - ❑ key assumptions and facts surrounding these loss contingencies.<sup>264</sup>
- ❑ Keep abreast of changes in relevant standards, policies and market practice affecting environmental accounting, since many expect FAS 5 and its related guidance to be replaced by “fair value” standards. In particular, monitor the following pending changes:
- ❑ FASB’s forthcoming final Staff Position guidance on applying FAS 141R;
  - ❑ FASB’s pending Proposed Statement on FAS 5 and FAS 141R Loss Contingency Footnote Disclosure and any related “alternative model”;
  - ❑ FASB and IASB’s GAAP harmonization initiative; and
  - ❑ The SEC’s potential transition from U.S. GAAP to international GAAP.

C. *Climate Change*

In addition to the relevant measures set out above, a company should:

- ❑ Consider assigning personnel to be responsible for keeping abreast of relevant developments in this area, coordinating climate change disclosure efforts, liaising between different groups within the company (e.g., environmental, legal, financial, supply chain managers and personnel from each affected business segment) and otherwise ensuring the company’s disclosure controls for climate change risks are sufficient.
- ❑ Continue to evaluate whether climate change risks need to be disclosed under existing regulations—Items 101, 103, 303 and 503(c) of Regulation S-K—or accounting guidance, including FAS 5 and FAS 141R.
- ❑ As a best practice, consider using the NY Attorney General settlements described in Section V.D above as a starting point for evaluating the adequacy of disclosure, particularly if subject to more significant climate change risks (e.g., power companies or those in the tourism industry).
- ❑ Review all climate change information the company may make available elsewhere, such as on its website, in voluntary sustainability reports and to organizations such as the Climate Disclosure Project and ensure (i) these voluntary disclosures do not conflict with its SEC

---

<sup>264</sup> These procedures will aid a company in complying with the existing standards, and the resulting documentation could be useful if auditors require the information or if the SEC requests this information in the form of a comment in connection with their review of company filings.

disclosure and (ii) that any material information contained in these voluntary disclosures are also included in its SEC filings.

- ❑ Review any existing climate change disclosure as well as the need for any new climate change disclosure at least quarterly in light of the rapid changes in this area.
- ❑ Review the disclosure of other companies (especially those of competitors, suppliers and customers) for additional trends, litigation or issues that may need to be disclosed.

## VII. CONCLUSION

Environmental disclosure rules are complicated, and practical questions arise regularly. Growing concern about climate change and developing rules relating to environmental loss contingency accounting will lead to even more complex analyses and questions.

In order for any company to comply with applicable rules and meet 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 not to 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 the 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. In addition, public companies should consider whether customer expectations or demands or developments in the political or social investing arena should affect their SEC disclosure.

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

DAVIS POLK & WARDWELL

Inquiries concerning the matters covered by this memorandum, as well as requests for additional copies, may be addressed to Betty M. Huber, Brianne Lucyk or any of the other lawyers in the Environmental Practice Group.

**Gail A. Flesher**, Partner  
212-450-4469 | [gail.flesher@dpw.com](mailto:gail.flesher@dpw.com)

**Loyti Cheng**, Counsel  
212-450-4022 | [loyti.cheng@dpw.com](mailto:loyti.cheng@dpw.com)

**Betty M. Huber**, Counsel  
212-450-4764 | [betty.huber@dpw.com](mailto:betty.huber@dpw.com)

**Heather Daly**, Associate  
212-450-4187 | [heather.daly@dpw.com](mailto:heather.daly@dpw.com)

**Hayden S. Baker**, Associate  
212-450-4727 | [hayden.baker@dpw.com](mailto:hayden.baker@dpw.com)

**Marie-Christine Eldridge**, Associate  
212-450-4814 | [marie-christine.eldridge@dpw.com](mailto:marie-christine.eldridge@dpw.com)

**Brianne Lucyk**, Associate  
212-450-4861 | [brianne.lucyk@dpw.com](mailto:brianne.lucyk@dpw.com)

**Elisabeth Mountainspring**, Associate  
212-450-4251 | [elisabeth.mountainspring@dpw.com](mailto:elisabeth.mountainspring@dpw.com)

**Jonathan C. Pentzien**, Associate  
212-450-4927 | [jonathan.pentzien@dpw.com](mailto:jonathan.pentzien@dpw.com)

**Ron E. Garber**, Associate  
212-450-4276 | [ron.garber@dpw.com](mailto:ron.garber@dpw.com)

© 2009 Davis Polk & Wardwell

---

*This memorandum is a summary for general information only. It is not a full analysis of the matters presented and may not be relied upon as legal or accounting advice.*